BUSINESS ORGANIZATION AND COMBINATION

By

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Preface to Third Edition

The treatment of the forms of business organization and combination in this book follows the same general outline and point of view as that of earlier editions. The objective is to describe the simple or independent types of business enterprise, such as the single proprietorship, the partnership, and other forms, and to show how more complex forms of organization have been built up with the simpler types as the constituent units. The forms of combination include loose organizations such as trade associations and interlocking directorates and more compact and permanent organizations such as consolidated companies and holding companies. The primary purpose of the present edition has been to bring the discussion up to date.

The seven years which have elapsed since the second edition appeared have been marked by the completion of the reforms in the field of business organization which were initiated by the New Deal administration in 1933. The most important new laws in the field are the Trust Indenture Act of 1939 and the Investment Company Act of 1940. The reorganization of public-utility holding companies under the Public Utility Act of 1935 has proceeded, though not as rapidly as had been anticipated. Partial delay is attributed to the war and to the failure of the Supreme Court to pass upon the constitutionality of the Act.

The increasing influence of the government in business has been manifest in many directions. The lending activities of the government, which were greatly increased during the war period, have resulted in an increased reliance of business upon government and a relaxation of the ties between private business and the investment banks. The requirement that certain types of corporations obtain competitive bids for new issues of securities has resulted in a further decline in the influence of the investment banks in corporate and other organization.

In the present edition, the discussion of the corporation has been enlarged by the inclusion of two new chapters, one dealing with bonds and the relation of the bondholder to the corporation, and the other dealing with corporate failure, dissolution, and reorganiza-

tion. These chapters are designed to give the student a view of additional phases of corporate organization and to complete the life history of the corporation.

The investment company, formerly called the investment trust, continues to occupy an anomalous position in the field of business organization. In earlier editions the investment company was treated as a corporate stockholder, and the chapter describing its organization and activities was included in that part of the book which dealt with the corporation. However, the investment company seems to have a broader significance than that of a corporate stockholder. Moreover, the investment company has been used as the medium for numerous corporate and financial abuses and has been made the subject of specific legislation and regulation. For these reasons, the investment company has been treated in a separate part of the book.

The increasing centralization of corporate and industrial activity is manifest in the organization of national and international cartels, which have been made the subject of a new chapter. That such cartels existed before the war was generally known, but the extent to which American corporations had entered into international cartels was not recognized until the United States became involved in the war in 1941. The international organization of business and industry is likely to increase in importance and to constitute a major problem in future years.

The chapter on coöperatives has been enlarged in the present edition to include some forms not dealt with earlier. It is hoped that the treatment of consumer and other coöperatives will aid the student in acquiring a balanced view of business organization.

The author wishes to express his appreciation of numerous suggestions which have been received from teachers who have used the former editions and from other persons, including the students in his classes. These suggestions have resulted in numerous improvement both in general organization and in the detailed treatment of the subject.

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Preface to Second Edition

Since the first edition of this book appeared in 1934, a number of important developments have occurred to necessitate a revision. The securities legislation of 1933, enforcement of which was entrusted to the Federal Trade Commission, was enlarged in 1934 to include the regulation of securities exchanges; and the Securities and Exchange Commission was established to administer the new legislation as well as the Act of 1933. In 1935, a Public Utility Act was passed. This Act has already resulted in materially changing the organization and methods of operation of public-utility holding companies and undoubtedly will have a still greater effect when its provisions become fully operative. The National Industrial Recovery Act of 1933, which had far-reaching effects upon trade associations, was declared unconstitutional in 1935; but since that time its effect has been apparent upon not only trade associations but also gentlemen's agreements, basing-point systems, zone-price systems, and pools. There have been numerous developments in the field of chain stores, where legislation, both state and Federal, has been enacted to tax the chain store and to improve the competitive position of the small independent. In this edition, an effort has been made to take these and numerous other recent developments into account.

Four new chapters have been added. These chapters deal with the Control of Security Issues, the Economics of the Corporation, the Chain-Store Problem and Price Legislation, and the Present Status of Antitrust Legislation.

The assistance rendered by two of the author's colleagues in connection with the revision is acknowledged. Mr. Orton W. Boyd, Lecturer in Business Administration and financial expert of the Securities and Exchange Commission, read and criticized Chapter IX; and Mr. S. C. Oppenheim, Associate Professor of Law, rendered invaluable assistance in connection with Chapters XXIX, XXX, and XXXI.

RICHARD N. OWENS

Preface to First Edition

This book is a study of simple or independent types of business enterprise, such as the single proprietorship, the partnership, the joint stock company, the Massachusetts trust, and the corporation, and of the interrelated and more complicated forms of business organization in which the simpler types are the constituent units. Thus, the interrelated forms of organization include gentlemen's agreements, pools, trusts, interlocking directorates, consolidations, holding companies, trade associations, and the like. It is hoped that through the discussion of these various forms of organization and combination, the student may obtain a picture of business as it is organized and conducted in America today.

The discussion of the interrelated forms of business organization has required some treatment of the economic and legal aspects of the problem. Thus, Part III, on industrial combination, contains a discussion of the combination movement and the economics of combination; and Part V, on the regulation of combinations, contains a discussion of the regulation of business combination and competitive practices by the common law and by state and Federal legislation. Although the future of government regulation of business organization and combination is at present somewhat uncertain, a chapter on the National Industrial Recovery Act has been included and other New Deal legislation has been reviewed in various chapters throughout the book.

The types of business enterprise that are discussed are principally the types used in organizing private enterprises, not public or governmental enterprises. The field of government enterprise itself is already large, and it is rapidly expanding. In the United States, it includes many enterprises that are owned and operated by cities, counties, states, and other governmental units. Prior to 1933, the Federal government conducted a great many business enterprises; and while this field of activity has already greatly expanded since March, 1933, it promises to expand still further in the future, partly as a result of a new social philosophy and partly as a result of the many loans made to private businesses and of the purchase of the stock of commercial banks by the government through the Reconstruction Finance Corporation. Abroad, governments have em-

barked upon numerous socialistic and communistic undertakings. Thus, the organization of the business enterprises of governments might logically be considered a part of the study of business organization. However, it has seemed desirable to leave their study to courses in socialism and economic reform. Yet it will be found that in the chapter on the history of the corporation, the importance of the municipal corporation in the development of the business corporation, and also the use of the corporation in organizing governmental business activities, are discussed.

The point of view throughout the book is largely historical and descriptive. The attempt has been to trace the historical development of each form of business organization, to describe it, and to indicate the purposes for which it is being employed. The arguments for and against each form of organization have been presented, but in most cases the teacher and the student have been left to decide on which side the balance of the argument lies. This is believed to be the proper point of view for a book that is intended to be used as a text.

The author wishes to acknowledge his indebtedness for the aid which he has received from many sources. Throughout the book an effort has been made in the footnotes to acknowledge the assistance that has been received from various printed sources. It is believed that the footnotes will be of much value to teachers and students in further study of the topics discussed. In addition, the author has received direct assistance from many persons. Professor C. D. Benson, of the George Washington University Law School, read preliminary drafts of Chapters I to X and Chapter XXII, and offered many valuable suggestions as to both content and sources. Dean M. O. Ross of Earlham College read Chapters I to IV and XI to XIV. Dr. C. W. Gerstenberg read Chapters VI and XV. Mr. L. B. Mann, a specialist in coöperative marketing at the United States Department of Agriculture, read Chapter XXI. Dean E. H. Johnson of Emory University read Chapters XI to XVI and Chapter XIX. Dr. W. H. S. Stevens and R. S. Ely of the Federal Trade Commission read Chapter XXVII. Mr. F. M. Feiker, formerly chief of the Bureau of Foreign and Domestic Commerce, read Chapter XX. Dr. Ralph D. Kennedy and Belva Margaret Owens read the entire manuscript. Each of these persons has earned the gratitude of the author by his constructive criticisms, although the author must assume responsibility for whatever shortcomings the book may be found to have.

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INTRODUCTION

CHAPTER I

The Forms of Business Organization

A business organization is an enterprise engaged in the production of goods or services for sale in a market. The primary objective of the enterprise is profit to the business thus engaged, although the actual result may sometimes be a loss. There are other objectives of business enterprise, such as the satisfaction of the desires and the needs of customers or consumers, aid to the government in carrying out its program for the nation in war or peace, the development and the conservation of national resources, and the providing of safe and productive employment for wage earners.

The market for the goods or services produced may be local, sectional, or nation-wide in scope, and it includes any place where goods are sold or services rendered, such as local stores and other local places of business as well as nationally organized markets like the live-stock markets or the grain and cotton exchanges.

The production of goods includes all activities which are designed to increase the desirability of the wares to consumers. Manufacturing is production, not because it creates goods or materials, but because it changes the form of materials and fashions the product in a manner which increases its value. The storing of goods in warehouses for future use is also production because the goods are held until a later time when their value to consumers is greater than when they were stored. Transportation agencies, such as trucking, railway, steamship, and airplane companies, are also engaged in production and in business because they transport goods to places where they are more desired and thus increase their value.

The owners of the business enterprise usually prescribe the general policies. Regardless of the form of organization, the owners decide such questions as the kind of goods to be manufactured, the type of merchandising activities to be carried on, or the nature of the services to be rendered to customers. They also decide upon the

size of the business, the amount of capital to be paid in, and the amounts to be raised by borrowing. Other problems for determination of the owners are the location of the principal office, factories, branches, or other places of business and the form of legal organization, as single proprietorship, partnership, or corporation. If the business is large enough to be divided into departments, the owners may decide what the departments shall be, what officers shall be authorized to direct each department, and how the departmental activities shall be correlated through the work of a president or general manager. Thus, the first task of the owners is to set up the general framework of the organization.

After the business has begun to operate, the owners or their representatives must supervise its activities and perhaps consider possible changes in its general policies. New capital may be required from time to time. Bank loans may be sought or the owners may be asked to supply additional capital. New lines of merchandise may be added or old lines may be discontinued. The dissolution of the business itself may be considered under certain circumstances as a result of financial or other developments.

More detailed policies of management must be considered from time to time. These include salaries to be paid to officers and employees, distributions of profits to the owners, contracts for the purchase of land, advertising and sales promotion, and the formulation and approval of merchandising, financial, and other budgets. In many small businesses, the owners are able to attend to these problems, but in a large business they are unable to devote the time or to meet frequently enough to deal with them. They may therefore select certain of their number to constitute a board to represent them in exercising supervisory powers. The board is called by different names in various types of enterprise. It may be a board of directors, or governors, or trustees. The board usually selects a president and other officers who take over the active management of the enterprise. In very large businesses the president and other major officers confine their attention to the larger problems, and leave the formulation of more detailed policies and the making of many business contracts to others. For example, they might find it necessary to authorize others to buy materials and machinery; hire, train, and supervise the work of employees; design safety rules and regulations; employ and direct salesmen; make advertising contracts and prepare advertising copy; fix prices for the goods to be sold; arrange for special sales of merchandise; approve applications

from prospective customers for credit and make collections; set up and operate a system of accounting records and reports; and supervise a host of other details.

Along with authority necessarily goes responsibility. The owners hold the officers accountable for efficient management, and the officers in turn hold their subordinates accountable to them. Thus, there is throughout the organization a tapering of authority and responsibility, beginning with the owners who set up the general framework of the organization and leave some policy determination to officers chosen by them. The arrangement is indicated in the accompanying diagram.

To accomplish its objectives as indicated in the diagram, a business enterprise may be organized as a single proprietorship, a partnership, a joint stock company, a business trust, or a corporation. Regardless of the form of legal organization, all of the activities indicated must be provided for.

In a single proprietorship the owner may perform all of the business functions. A single proprietorship is a business owned by one person. The owner may attempt to manage all phases of the business by himself, but he does not necessarily do so. He may organize the business into departments and place members of his family or other persons in charge of some activities. However, in many small businesses, such as retail stores, laundries, barber shops, and filling stations, the owner determines and executes all major and minor policies and performs much of the labor. He decides what the nature of the business will be and how much capital will be invested. He supplies the capital, makes contracts for the purchase of merchandise and equipment, employs help when necessary, makes sales, pays expenses, and withdraws the profits when he sees fit to do so.

A partnership is an association of persons to own and operate a business on a joint basis. In forming a partnership, two or more persons agree to supply the capital, time, and ability and experience for the operation of a business for profit and under joint management. They enter into a contract called a partnership agreement. The agreement sets up the general framework of the business. It makes provision for the amount of capital to be invested by each partner, indicates the place of business, the kind of merchandising or other activities to be conducted, the method of dividing profits, the duration of the enterprise, and other fundamental policies.

The partners compose the board for the supervision of business

Owners

Furnish all or part of the capital.
Determine general objectives and policies.

Board of Supervisors, Directors, Governors, or Trustees

Represent owners in supervision of operating results and in carrying out program established by them.

President or Chief Administrative Officer

Correlates activities of various departments.
Approves proposals within scope of his authority, carries other problems to the board for approval.

Senior Officers

This group includes Sales Manager, Production Manager, Chief Accountant, and Finance Manager. They supervise and execute methods of attaining objectives of the enterprise in coöperation with the President.

Junior Officers

Heads of divisions within each of the major departments direct stenographers, bookkeepers, clerical employees, and others and see that work is efficiently conducted.

Workers

Carry out directions and perform work assigned. This group includes sales people, bookkeepers and others doing manual or clerical work.

General Organization to Conduct Activities of Business

activities. There is a significant difference between the partners as owners and organizers of the business and the partners as managers. Changes in the fundamental framework of the business as stated in the partnership agreement can be made only with unanimous consent of the members, while decisions on questions of administrative policy are decided by majority vote. One of the partners may be designated as senior partner and given authority similar to that of president in a larger organization, and the other partners may be

made responsible for the management of various phases of business activity. In many partnerships, all of the partners are consulted before any contracts for the purchase of merchandise, the employment of sales people, or other important activities are made. In fact, the partners may jointly perform all of the work and execute all of the policies without any delegation of authority.

In the joint stock company ownership and management may be separated. The joint stock company resembles a partnership in that it is based upon a contract between the members, but it differs from it in several respects. Since shares of the company may be purchased by anyone, it would be unwise to confer upon all shareholders the power to make contracts or to participate in the active management of the business. Instead, the members or shareholders set up the general policies and structure of the organization in their original agreement. They delegate responsibility for supervision of company affairs to a board called a board of governors. The board chooses a president and other officers as authorized in the original agreement or contract between the members. Since no exemption for debts of the business is provided by law, the owners are liable and may be assessed to make good the losses of creditors.

One individual may hold several places in the organization of a joint stock company. He may be a shareholder, a member of the board of governors, and an officer. However, the organization is based upon the assumption that many shareholders will not be on the board of governors or have any connection with the company besides that of shareholder.

The business trust requires a separation of ownership and management. The business trust is also based upon a contract. The contract creating the business trust is called a trust agreement. It provides that property or money shall be transferred to a group of persons called trustees. The trustees constitute a board for the administration of the affairs of the enterprise. They elect officers and they meet regularly to hear reports and to supervise business operations.

The peculiar feature of the business trust is that the original agreement fixes the general framework and structure of the enterprise which cannot later be changed by the persons who created it. The creators, who are the persons making the agreement with the trustees and paying the money or property over to them, have no power to interfere in any way with the administration of business affairs. They do not have the right to fill vacancies in the board of

trustees, which is a self-perpetuating body. The creators receive shares or certificates of ownership which entitle the holders to dividends when and if declared by the trustees. The shares may be sold; and when the trust is dissolved, they are retired with a pro rata share of the remaining property or assets. In this form of organization, the owners prescribe the general policies of the enterprise at the time of organization, but they have no voice in the management.

The corporation is created by the state upon application from the persons desiring its organization. It exists by virtue of its charter and it continues to exist until its life is legally terminated in accordance with the charter and the law of the state. The persons making application for the charter are called incorporators. The persons owning shares of stock into which its capital is divided are called stockholders. The members of the board elected by the stockholders to supervise corporate affairs are called directors. Officers are named by the directors to manage the business.

The directors are usually elected from the stockholders, and the officers may or may not be directors or stockholders. In many small corporations and some large ones, the principal stockholders are directors and also officers. In some large corporations, most of the directors and officers own a small amount of stock, but usually a few directors and one or more officers own substantial amounts. Thus, while the corporation makes possible the complete separation of ownership and management, such a separation may not be made. There is no legal requirement that the stockholders, directors, and officers be different groups of persons. On the contrary, many states require that each director own at least one share of stock, and the ownership of larger amounts is usually considered desirable.

As the principal forms of business organization are considered more fully in later chapters, most of the discussion will be concerned with the organization at the top, that is, with ownership organization. The organization of departments of a business and the duties of the various officers and their subordinates is beyond the scope of the present study.

Many businesses have joined with others to conduct some activities or to limit their freedom of action in the formation of some policies. A business enterprise may join with other companies in the same industry for the purpose of gathering statistics of trade, in designing and installing accounting systems, or in meeting other problems confronting the industry. They may also agree to sur-

render their freedom of action in dealing with some phase of management, such as fixing prices, bringing out new products, or increasing the quantities of product manufactured. Some of these agreements are illegal, but they are in fact occasionally made and must be regarded as one phase of policy formation. In some cases, one corporation acquires all or a majority of the stock of one or more other corporations; and the result of that arrangement is the concentration of the policy-making function in the managers of the corporation owning the stock. There are many forms of interrelationships between businesses. These forms have been developed largely since 1850 when industry began to organize on a national scale. The principal forms of relationships between businesses are as follows:

1. *The trade association.* Beginning about 1850 the manufacturers in various industries such as iron and brass began to organize associations for the mutual benefit of the members. During the ensuing decades, coöperation in industry through such associations assumed various forms. Their activities included the gathering of trade statistics, reporting on prices charged, and assistance to government in war-time. While the kinds of work carried on have changed from time to time, trade associations have played an important part in the business and industrial development of the country. Trade associations are active in the major manufacturing industries and also among retailers and wholesalers and smaller branches of manufacturing industry, such as soap and glycerine, screw machine products, paint and varnish, combed yarn, mineral wool, pressed metal, and kegs and barrels.

2. *The gentlemen's agreement.* The gentlemen's agreement is a loose organization of dealers and producers in an industry for the purpose of formulating some phase of business policy. It is based not upon a formal contract but upon an oral or implied agreement which is often secret. It depends for its enforcement upon the word of honor of the participants. Each member retains the ownership and control of his own business but he voluntarily limits his freedom of action in some respect. The trade association has frequently been the means of bringing the members of an industry together to form such agreements whereby manufacturers promise not to compete with each other or not to cut prices.

3. *The pool.* Pools differ from gentlemen's agreements in that they are based upon a definite contract. Pooling agreements fre-

quently contain elaborate provisions pertaining to such problems as the division of markets, the assignment of production quotas to the members, and the limitation of the amount to be produced. They became common in many branches of industry following the close of the Civil War. During recent years and particularly since 1930, the pool has again become a favored device for limiting competition.

4. *The cartel.* Cartels originated in Germany and are still commonly associated with that country. They are very similar to the pool, but in Germany they have been subject to government regulation. Cartels are either national or international in scope. International cartels frequently include corporations in the United States and Japan in addition to corporations in various countries in Europe. They are designed to divide world markets and to limit production. So far as the United States is concerned, they are illegal.

5. *The trust.* The trust is no longer used as a method of business organization because it is illegal, but it was a common form of organization of large enterprises during the years 1879 to 1892. It provided for the transfer of the voting stock of most or perhaps all of the corporations in an industry to a board of trustees, who thus acquired control of the member companies. This form of trust, sometimes spoken of as the trustee device, differs from the business trust previously referred to in that its assets consisted of the stocks of the corporations in an industry, whereas the assets of the business trust consist of land, buildings, and other properties or of small blocks of stocks and bonds for investment purposes only. It is important as a step in the development of the large corporation.

6. *The community of interest.* This type of organization is a continuous coöperation between two or more corporations or other businesses as a result of one or more persons holding positions on the board of directors of the corporations or being partners if the businesses are organized as partnerships. The coöperation usually takes the form of purchases and sales from one to the other, or an industrial corporation may give its banking business to a bank as a result of the existence of the community of interest. This type of arrangement first achieved national scope during the decade of the 1890's, and it is now a significant fact in our economic organization.

7. *The consolidated company.* The consolidated company is a corporation which owns the properties formerly owned by two or

more previously existing corporations. As only one company exists after two or more corporations are combined, it might be said that this is not a distinct form of business organization. However, many unusual features exist in such a corporation and it merits separate treatment.

8. *The holding company.* The holding company is a corporation which owns all or a majority of the stock of another corporation, or which owns enough of its stock to be able to elect the board of directors and thus control its policies. Holding companies have increased greatly in importance since 1892 when the trust was held to be illegal and a new form of organization was needed in industry.

9. *The leased company.* During the years immediately preceding the Civil War and to a greater extent during the years 1880 to 1900, many large railway systems were built up by lease arrangements. These provided that one company would lease its entire property including locomotives and railway cars to another at an annual rental for a fixed term of years. The corporation owning the property, called the lessor corporation, remained in existence throughout the period of the lease in order that it might receive the rental payments and distribute to its own stockholders the amounts received. It also remained in existence that it might receive the return of the property at the expiration of the lease. Few lease arrangements are being negotiated at the present time, but many properties now operated by our large railway systems are controlled by virtue of lease agreements entered into many years ago.

10. *The coöperative.* A coöperative is an association of persons or businesses to conduct commercial or other activities for the benefit of all the members. Coöperatives are active in many fields of merchandising, production, and finance, including agriculture, insurance, and banking. They include credit unions, stock exchanges, and taxicab associations.

Questions

1. What are the two things that characterize a business enterprise? Does the sale of merchandise or services in a market always mean sale for a profit?

2. For what reasons other than desire for profit would a person engage in business?

3. What is meant by market?

4. Is the local retail store engaged in production? A shoe shine parlor?

5. What policies are usually prescribed by the owners of an enterprise?

6. What is the function of the owners of an enterprise after its organization?

7. What is the function of a board of directors in a corporation?

8. What authority does a sales manager need to carry out his responsibilities?

9. What authority does a personnel manager need?

10. Show that authority should be accompanied by responsibility.

11. How may a general manager of an enterprise know that his subordinates are doing their work well?

12. Do officers below the president in the administrative organization have any part in the formulation of policies of the business?

13. What is the position of the owner in the administration of an enterprise organized as a single proprietorship? Does his position change as the business grows in size?

14. Are ownership and management always separated in the joint stock company?

15. Are ownership and management always separated in the business trust?

16. Are ownership and management always separated in the corporation? Should they be separated?

17. Can a small enterprise be organized as a corporation?

18. What are the reasons why one business combines with others to organize a trade association? To form a consolidated company?

19. What is a gentlemen's agreement? How can it be considered a form of business organization?

20. How is the pool related to the formulation of business policies?

21. How does the corporate chain store differ from the coöperative chain store? Give examples of each type of chain store.

22. What is a coöperative? In what sense is the stock exchange a coöperative?

PART ONE

Non-Corporate Forms of Business Organization

CHAPTER II

The Single Proprietorship

The single proprietorship is the oldest form of business organization, having existed from the very beginning of business. Throughout the centuries of business development, the small proprietor has held a prominent position even though other forms have appeared to be better adapted to certain activities or enterprises. So persistent is the small business that even now it plays an important role in our economy.

I. The Importance of the Single Proprietorship

The single proprietorship is not adapted to some fields of business activity, but in other fields it is more than a match for larger enterprises organized as corporations or otherwise. The fields where it holds an important position include agriculture, retail selling, certain branches of manufacturing, and consumer service.

The single proprietorship has always held an important place in agriculture. The farmer must be regarded as a business man because he sells a part of his product in the market. The percentage of his product which he sells has shown a decided increase in recent years, partly as a result of specialization in the growing of a few varieties of crops and partly as a result of the mechanization of agriculture. The farmer has had to sell an increasing percentage of his product in order to buy tractors and other machinery, repair parts, gasoline, and fertilizers. The single proprietorship is peculiarly adapted to farm production because each person employed on the farm usually works by himself on a relatively small piece of land. Such questions as what crops to plant on each plot of ground, when to plant, how and when to cultivate the land, and when to

harvest the crop are best decided by persons close to the land itself. The amount of capital required can usually be supplied by one person, though some loans may be required.

The single proprietor still holds an important place in retail trade. The rise of the chain store, the mail order house, the department store, and the large specialty store, many of which are organized as corporations, has been so spectacular that the position retained by the small proprietor is likely to be overlooked. However, at the beginning of the Second World War, seventy-six per cent of the retail stores in the United States were owned by single proprietors. Partnerships owned 10.7 per cent of the stores, corporations owned thirteen per cent, and coöperatives and other forms of organization less than one per cent. In volume of sales, single proprietorships accounted for 39.3 per cent, partnerships 12.4 per cent, corporations 47.1 per cent, and coöperatives and other forms about one per cent. About half of the retail stores were so small that they hired no employees.

In the wholesale trade also, the single proprietorship plays an important part. In 1939, single proprietorships owned 36.6 per cent of the wholesale establishments in the United States. Partnerships owned 12.6 per cent, corporations 48.6 per cent, and coöperatives and other forms of organization 2.2 per cent. As in the case of retail trade, however, the wholesale businesses owned and operated by individuals were the smaller ones. They accounted for only 12.6 per cent of the sales.

The small business has several advantages in distribution. First, the amount of capital required for the average store is not large. Second, the retail store is usually located near the customers and is not easily supervised from a distant office. Third, the personal service desired by customers may, at least in many cases, be best rendered by the individual proprietor. Fourth, in some localities, customers desire special qualities of merchandise which may be supplied on a personal basis by someone who knows their needs and their preferences.

In manufacturing, the single proprietorship is decreasing in importance. With the coming of machine processes of manufacture and the transfer of production from the home or small shop to the factory, the single proprietorship was unable to supply the amounts of capital required in many branches of manufacturing. In England the single proprietorship definitely began to decline in importance about the last quarter of the eighteenth century. In the

United States it has gradually decreased in importance since about 1800. The total number of manufacturing establishments in the United States in 1939 was about 184,000 of which 59,000 were owned by single proprietorships, 28,000 by partnerships, 95,000 by corporations, and 2,000 by coöperatives and other forms of organizations. The number owned by individuals was about 16.5 per cent of the total. These were of course the smaller establishments. The number of wage-earners employed in manufacturing plants owned by single proprietors was only 5.6 per cent of the total and the value of their products was only 3.5 per cent.

In some parts of the country, small manufacturing plants predominate. Thus, in New York City there are 35,000 manufacturing plants of which 15,000 employ less than five persons each. Most of these are located in lofts or old industrial buildings. Many are engaged in some branch of clothing manufacture. In other sections of the country, as Detroit and Pittsburgh, large corporate establishments assume a much greater importance.

The branches of manufacturing in which the single proprietorship is important have one or more of the following characteristics: First, only a small amount of capital is required. Second, the bulkiness of the product, as sand, gravel, brick, and cheap furniture, may require that the goods be produced near the consumer, and in some cases this means in relatively small establishments widely dispersed. Third, the product may be perishable or may be adapted to the needs of the individual consumer. This is true, for example, of tailor-made clothing, dresses, photographs, bread, and vegetables used in canning. Fourth, the hazard of style change may be great. This risk may be reduced by the small organization which is flexible and can readily change in response to changes in the market. This fact probably explains the persistence of the small establishment in many branches of the clothing industry.

The single proprietorship is most important in the service industries. Service industries, as the name implies, are those which perform some labor or activity desired by customers. The following are included in the service industries as defined by the Bureau of the Census:

Advertising agencies
Auctioneers
Barber shops
Baths and masseurs' establishments

Cleaning, dyeing, pressing, and alteration establishments
Cleaning and renovation of hats
Costume and dress-suit rental agencies
Funeral directors
Fur repair and storage
Laundries, hand and power
Linen supply
Parking lots
Rug cleaning
Shoe repair
Shoe shine
Tourist camps
Travel agencies

In 1939 there were 646,000 service establishments in the United States, of which approximately 556,000 or 86 per cent were owned and operated as single proprietorships. Partnerships were next in importance with 61,000 establishments or nine per cent, while corporations controlled only 28,000 or slightly less than five per cent. The principal reasons for the predominance of the single proprietorship in this field are the personal nature of the services rendered, the necessity for location near the customer, and the relatively small amount of capital required.

The mortality rate among small businesses has been high. The usual experience has been that thirty per cent of new enterprises disappear within one year after their organization and fifty per cent disappear by the end of the third year.[1] A large percentage of these failures occur among small businesses. The more important causes of failure are indicated in the outline which follows: [2]

Causes of Failure Among Small Businesses

1. Unwise organization.
   Poor location.
   No need in the community for the business.
2. Managerial incompetency.
   Inadequate experience or training of the proprietor.
   Neglect of the business for other interests.

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[1] Bureau of Foreign and Domestic Commerce, *Small Business—A National Asset*, p. 17. July, 1943.

[2] Adapted from John H. Cover, *et al.: Problems of Small Business*, T.N.E.C. Monograph 17, Washington, 1941.

Neglect of personal appearance.
Carelessness in the handling of merchandise.
Inadequate accounting records.

3. Inadequate capital.
   Original capital inadequate.
   Loss of capital through fraud.
   Too much capital from borrowing, too little supplied by owners.
4. Poor financial management.
   Improper investment of assets. Too much in land and building, not enough in inventory and working cash balance.
   Poor control of costs of operation.
   Expenses and costs not properly related to sales; low sales volume.
   Bad debt losses.
   Inability to meet competition.
5. Personal affairs.
   Illness.
   Friction between the partners, in the case of a partnership.
   Extravagance in personal or business affairs.
   Indolence.
   Speculation with business or private funds.
6. Inadequate government protection.
   Failure to protect against unfair competition.
   Monopolistic prices charged by vendors.
   Discriminatory prices allowed competitors.

Many small businesses discontinued during the war. The number of small businesses disappearing was particularly great during the years 1941 to 1943; and though many businesses were discontinued for reasons other than failure, many of them failed. More than half a million businesses or fifteen per cent of the total were discontinued during the first two years after the United States became involved in the war. The number of discontinued businesses was greatest in those branches of commerce and industry where small business predominates, including automotive dealers, building material dealers, and household appliance and radio stores.[3] During the war period, small proprietors were confronted with a number of new hazards in addition to those already enumerated. These included the scarcity of materials and merchandise, the shortage of labor, and the employment opportunities in war industries. Many proprietors were themselves inducted into the armed forces while others found it profitable to discontinue their businesses and

[3] H. R. Bowen, D. W. Paden, and Genevieve Wimsatt: "Business Population in Wartime," *Survey of Current Business*, May, 1944.

accept employment at day wages. Other problems growing out of the war were the rationing program for meats and processed foods; priorities for materials; reports required by the government; deductions from employees' pay for war bond purchases, income taxes, and possibly union dues; the complexities of income taxes, excess profits taxes, and excise taxes; and regulations concerning the extension of credit to customers. The single proprietor has had great difficulty in conforming to the numerous regulations because it has been difficult for any one person to keep informed in all of them.

Small business will survive the war period. The success of the single proprietor in meeting new situations since the beginning of business and the willingness of persons with a small amount of capital to risk it even though others have failed, indicate that the small proprietor will recover from his wartime reverses. From 1900 to 1941, the number of business firms increased more rapidly than the population. In the nine years preceding our becoming involved in the Second World War, the rate of growth was greater than in any period since 1900.[4] In fact in the middle of 1943, the number of establishments was about the same as it was in the year 1933. It seems likely that the number of single proprietorships has been only temporarily decreased by the problems of the war period.

The state and Federal governments have enacted many measures designed to aid small business. In a business economy where reliance is placed upon competitive forces for the control of prices and production, the government is interested in aiding small business to survive or at least in seeing that it is not eliminated by unfair competitive methods. The following measures are especially designed to aid the farmers, who are the most numerous of our single proprietors:

1. Research in methods of crop production, soil conservation, pest control, and other farm problems. Research of this kind is carried on by the Department of Agriculture and by state universities; and the information is disseminated by county farm agents, radio programs, publications, and other means. The large corporation may finance its own research in production and distribution, but the small producer depends largely upon a governmental agency.

2. Loans to farmers by lending agencies organized and financed

[4] H. R. Bowen: "Trends in Business Population," *Survey of Current Business*, March, 1944.

by the Federal government. The rates of interest charged on loans made to farmers have been materially reduced as a result of the activities of the Federal government. The principal agency which extends credit to farmers is the Farm Credit Administration, which exercises supervision over various lending corporations and banks, including Federal land banks, the Federal Farm Mortgage Corporation, the Intermediate Credit Banks, the Production Credit Corporation, the Central Banks for Coöperatives, and the Joint-Stock Land Banks.

3. The encouragement of farmers' buying and marketing coöperative organizations by both state and Federal governments and the exemption of farmers' coöperatives from the operation of the antitrust laws.

4. The rural electrification program which is designed to supply the farmer with cheap electric power.

5. Crop insurance provided by the government. This is designed to protect the farmer against crop failure due to drought or other unfavorable weather conditions.

6. Production and price control plans together with soil conservation. These plans are designed to provide in some degree the control which might be exercised by a large corporation having a monopolistic position in an industry. They include a subsidy to the farmer from the Federal treasury.

Several laws have been enacted to help small retailers or to retard their large competitors. No attempt is made here to appraise the results of the laws, though it may be pointed out that some of them remain in the controversial stage. The principal measures are as follows:

1. Taxes on chain stores in many states. Some of these are graduated according to the number of stores owned and operated within the state by one company, and some are graduated according to the number of stores in the United States rather than in the one state.

2. Resale price maintenance laws which make it possible for the manufacturer to control the price at which his product may be sold by the retailer, and Fair Trade laws prohibiting sales below cost. Such laws have been enacted in many states. These laws are especially directed at price cutting by chain stores.

3. The Robinson-Patman Act, enacted by Congress in 1936, which prohibits price discrimination by manufacturers, wholesalers, and others. This law is designed to prevent unfair price concessions to chain stores and department stores which have been able to procure special prices and thus to obtain a competitive advantage over the small independent retailer.

4. The Tydings-Miller Act, enacted by Congress in 1937, which legalizes price maintenance contracts in interstate commerce when such contracts are lawful in intrastate commerce by the law of the state in which the product is offered for resale.

The following laws are designed to help small businesses in general but particularly those engaged in manufacturing:

1. The antitrust laws which prohibit combinations in restraint of trade. The first Federal law of this kind was the Sherman Antitrust Act of 1890. Similar laws have been enacted by most of the states.

2. The prohibition of unfair methods of competition in commerce. This law, enforcement of which is entrusted to the Federal Trade Commission, is designed to prevent a corporation from putting its competitors out of business by unfair methods.

3. A graduated tax upon corporate income, the tax rate increasing with the size of the corporation.

II. Organization and Characteristics of the Single Proprietorship

Although the single proprietorship is still important, it will not be necessary to describe it at length. There are no complicated or involved relationships with other persons such as are found in the partnership, the corporation, and other types of business enterprise. Only the rights of the single proprietor and the creditors need to be considered in organizing, operating, and dissolving the business. Moreover, the reader is already familiar with its operation, and no doubt can recall numerous examples of farms, drugstores, restaurants, garages, filling stations, barber shops, and other small businesses which are operated as single proprietorships. All that is necessary here is to enumerate its salient characteristics.

The single proprietorship is easily organized. No formalities are required to organize a business as a single proprietorship. The

owner may have to pay only the fees required of all businesses engaging in that particular activity. In most cities license fees are required of such businesses as stores, restaurants, drugstores, and theaters.

The ease with which a single proprietorship may be organized is usually considered an advantage, but it may prove to be a disadvantage. Greater formality in the organization requirements might require more thought to be given to a projected enterprise. A serious social waste as well as individual loss results from the heavy mortality of small business enterprises.

The single proprietorship places all of the burdens of management upon the owner. The owner makes all of the decisions and manages the various phases of the business by himself. Few persons are qualified by training or experience to handle alone the varied problems of purchasing, merchandising, advertising, customer relations, and financing. Many persons have taken others into partnership because they needed assistance in management. The single proprietorship is unsuited for the specialist.

Not only may the owner be required to handle all of the problems and make all of the decisions of the business, but he may be compelled to do this all of the time. He becomes tied to the business in a way that most managers do not like. In a partnership the burden of management may temporarily be shifted to other partners, and in a large corporation there are usually understudies who may take over the duties of the superior officers of the business during periods of vacation, illness, or other absence. Even though the single proprietor may delegate some duties to others, he still must bear all of the risk and assume all responsibility for what is done.

The single proprietorship involves great risk for the owner. The risk arises from the fact that the owner is liable for all of the debts of his business, not merely for the amount of his investment in it. If the business fails, the creditors may take both his business and his personal property, or as much of it as is necessary to pay their claims. This is a serious disadvantage of both the single proprietorship and the partnership.

In one respect the single proprietorship involves less risk than other forms of business organization. The proprietor is not required to take anyone into his confidence or to entrust his business affairs to others. He does not run the risk of taking an incompetent or otherwise undesirable person into his business as a partner. If

his business fails he may lose more as a single proprietor, but he may be less likely to fail. It has already been pointed out, however, that his own unfamiliarity with certain phases of business management may operate to cause his failure.

The proprietor is likely to take a great interest in his business. The single proprietorship has the advantage of affording great motivation to careful and efficient management. Most large businesses of today are managed by paid managers who have little financial interest in the success of the enterprise which they direct. The sole owner receives all of the rewards of the financial success of his business and bears all of the losses in case of failure. He has every incentive to work faithfully for its advancement.

The single proprietorship is at a disadvantage in raising capital. The proprietor does not have to supply all of the funds for his business, for he may borrow from the banks or on the security of a mortgage, as do other businesses, and he may purchase merchandise on credit. If he continuously owes for merchandise, buying more goods as fast as he pays some of his accounts, the wholesalers or manufacturers from whom he buys permanently supply a part of his capital. There is a limit, however, to the amount that others will supply or can safely supply. Hence, the owner himself must invest a certain percentage of the required capital, the exact percentage depending upon the attitude of his creditors and the rapidity with which he can convert his merchandise and his accounts receivable into cash. It is recognized as very dangerous for any business to attempt to operate with a small amount of capital—in fact, inadequate working capital is one of the common causes of financial failure. Therefore, since the amount of capital which a single individual can supply is limited, most businesses requiring large amounts of capital must be organized in some way other than as single proprietorships. However, the unlimited liability of the sole proprietor facilitates the raising of capital by making it easier to borrow from others, since outsiders will more readily lend or sell merchandise on credit if the proprietor is known to have property outside the business which might be seized in settlement of their claims.

The single proprietorship can be terminated at any time. As no legal formalities are required in organizing a single proprietorship, so none are required for terminating it. The assets may be sold and the liabilities liquidated at any time, and the proprietor is not required to consult anyone so long as the claims of outsiders are

met. On the other hand, he may continue the operation of the business to suit his own pleasure: there are no dissatisfied partners or stockholders to force its dissolution.

The single proprietorship is a socially desirable form of organization. The interests of society lie in proper motivation, the diffusion of business ownership, and business efficiency. The concentration of property ownership in the hands of a few persons is generally considered to be undesirable, regardless of the use to which the property may be put, and the concentration of the control of industry in the hands of a few persons who have relatively small financial interests at stake is considered to be even more objectionable. The preservation of the single proprietorship offers the best promise of securing motivation and widespread ownership and control of industry.

Questions

1. What are the disadvantages of the single proprietorship as a form of organization for an automobile manufacturing company?
2. Why is the single proprietorship suited to agriculture?
3. How are the problems of the farmer similar to those of a small manufacturing business?
4. How is the single proprietorship adapted to the retail merchandising business? What are its limitations as a form of organization for department stores? For chain stores?
5. Why has the single proprietorship declined in importance in manufacturing? In what branches of manufacturing is it still important?
6. Why is the single proprietorship peculiarly suited to the service industries?
7. Would you expect to find a higher mortality rate among small businesses than large enterprises? Why?
8. Would you expect to find as large a percentage of failures among branches of chain grocery stores as among independent grocery stores?
9. Which of the causes of failure among small businesses would usually be avoided by large corporations, such as chain stores or manufacturing enterprises?
10. What additional causes of failure increased business mortality during the war period? Did all discontinuances indicate failures?
11. Why is the government interested in preserving the small enterprise? Is it also interested in maintaining the large enterprise?
12. What has the government done to aid the farmer? The small retailer? The small manufacturer?
13. If the small enterprise is efficient, does it need protection?

14. Is ease of organization a disadvantage to the single proprietorship? Why?

15. Some single proprietors consider it an advantage that they can purchase their own merchandise at wholesale prices. What does this indicate as to the profits of the small enterprise?

16. Is the single proprietorship more risky than the partnership? In what respects?

17. Would the owner of a small enterprise be more likely to take chances or would he be more likely to play safe in comparison with the paid manager of a large business?

18. Why is the single proprietorship unsuited to the specialist?

19. What are the advantages and the disadvantages of the single proprietorship in the raising of capital?

20. Should the small enterprise be preserved even though it is less efficient than large businesses?

21. Why is widespread ownership of property desirable?

22. How is the position of the owner of a retail store different from that of a paid manager of a branch of a chain organization who owns stock in the corporation owning the chain?

23. Why is the single proprietorship not in danger of being entirely crowded out by large corporations?

CHAPTER III

The Partnership

The partnership is a common form of business organization today. Although it has declined in importance during much of the time since the advent of the corporation, many businesses have continued that form of organization or have returned to it, especially since about 1935, because of its favored position as to income and franchise taxes. The data presented in the preceding chapter show that the number of partnerships is still large although the total capital of partnerships is many times exceeded by the total capital of corporations.

I. Development of the Partnership

The partnership has existed since very early times. It had separate origin and development in each of several countries in ancient times, including China, India, Babylon, Greece, and Rome. After almost disappearing in western Europe following the Teutonic invasions, it once more appeared during the early part of the Middle Ages.

Many of the early partnerships were temporary arrangements. As trade increased in the Mediterranean area during the latter part of the Middle Ages, the size of the ventures increased to such an extent that many individual traders found themselves unable to supply the capital required. Partners were therefore admitted to furnish a part of the capital necessary for a single voyage in return for a share in the profits. The partnership came to an end when the voyage was completed and the profits were distributed, along with the original capital. One of the members of the partnership frequently assumed full responsibility for the management of the enterprise. He accompanied the vessel to the port for which it was destined, sold the merchandise, and returned to the home port with the proceeds which might be in money or merchandise. In some cases the managing partner took the money to

a distant port for the purchase of merchandise which was disposed of upon return to the home port or city. The merchant who accompanied the shipment usually furnished less than half of the capital, and often he furnished none of it; if he furnished one-third of the capital, he usually received one-half of the profits although the distribution of profits was agreed upon when each partnership was formed. The venture was known as a *commenda* and each participant as a *socius*.

The partnership in land trade first included members of a family. The partnership based upon family relationship existed in the early oriental civilizations, particularly in China and India, and later in Babylon. At a still later period the partnership in which the partners were related by blood or by marriage appeared in the countries of the Near East and southern Europe. At first the son was taken into the business of the father, and later other members of the family not so closely related were admitted; and as a result of the identity of interests in the family, no distinction was made at first between family expenses and business expenses. As outsiders were admitted, it became necessary to distinguish between household expenses and business expenses.

Many features of the partnership grew out of the family relationship. One feature was the unlimited liability of the partner. Since in the early partnerships based upon the family relationship no attempt was made to separate business and family expenses, it was only natural to assume that in the settlement of partnership affairs the members would be liable for the debts of the partnership. Moreover, by the criminal law the family was sometimes held responsible for the crimes of any member. This was particularly true of treason, the whole family of the guilty person being punished and the home destroyed. In the time of Christ, a person who could not pay his debts might be sold into slavery together with his wife and children.[1]

Another feature of the partnership which may be traced to the family is that each member of the partnership may act as agent for the partnership. The head of the household very early acquired the right to act for the family and to make contracts in its name. In many countries, however, the right of the partner to bind the firm was not recognized at first, and it was not until the fourteenth and fifteenth centuries that the responsibility of the other partners for contracts made by an individual member of the firm was incor-

[1] Matthew 18:25.

porated in the statutes of the Italian city states. The decisions of many courts were long opposed to this view of the position of the partner.

In northern Europe the family as a business unit was not so completely developed, and there it was customary to require all members of a partnership to sign a contract. Gradually the idea developed that all members of the partnership were liable regardless of whether or not they had signed the contract. In England a seal for the partnership was adopted, and the attaching of the partnership seal to contracts bound all of the partners. In some cases each partner gave the others a power of attorney which permitted each to make contracts in the name of the partnership.

The partnership was important in England in early modern times. It is known to have existed in England as early as 1284, though its development came principally after that time.[2] The partnership became an important form of business organization in England as commerce and trade revived during the late Middle Ages. After about 1550 it began to be replaced in large business enterprises by the joint stock company. In the United States the partnership was used in many ventures during colonial times, and it has continued to be important down to our own time. Most of the large enterprises in manufacturing and other fields, however, are organized as corporations.

The partnership is still important in many fields of business activity. The lines of business in which the partnership is important are essentially the same as those where the single proprietorship holds an important position. They are usually characterized by the small amount of capital required, the importance of skill and judgment in management, and the rendering of personal service to customers or patrons. They include the following:

1. Small retail and wholesale establishments, restaurants, garages, gasoline filling stations, hardware stores, and specialty stores.

2. Certain lines of manufacture, particularly industries peculiar to cities. In this group are various branches of the clothing industry, such as men's furnishings, felt hats, millinery, lace goods, artificial flowers, and buttons.

3. Service industries, as listed in the preceding chapter.

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[2] William Mitchell: "Early Forms of the Partnership," in *Select Essays in Anglo-American Legal History,* Vol. II, pp. 183-190. Little, Brown, and Co., Boston, 1909.

4. The professions, as law, medicine, dentistry, accounting, and engineering.

Many businesses which were originally organized as partnerships are now corporations. The great Carnegie enterprises in the steel industry began as a small partnership in 1858. John D. Rockefeller, likewise, first entered the oil industry as a member of a partnership, the business being incorporated in 1870. The Baldwin Locomotive Works, founded in 1831, was a partnership until 1909. The Great Atlantic and Pacific Tea Company began as a partnership in 1859, though it was later conducted as a single proprietorship for a number of years. The Armour meat-packing business was a partnership until 1900, when it was incorporated under the name of Armour and Company. The meat-packing business of Gustavus Swift was incorporated in 1885, after having been conducted as a partnership for several years. The banking business of J. P. Morgan and Company remained a partnership until 1940, although the investment banking department which was engaged in the marketing of new issues of securities was separately incorporated in 1935 under the name of Morgan Stanley and Company.

II. The Nature of the Partnership

The partnership developed without detailed regulation by statute, but the common law rules relating to the partnership have now been generally embodied in the statutes of the various states. Many states have adopted a uniform partnership act which has helped to clarify doubtful questions.

The partnership is an association of two or more persons to carry on a business as co-owners for profit. It is based upon a contract between the members. Since contracts may be formed at common law, it follows that partnerships may be organized even though no statute has specifically authorized their formation. In this respect the partnership differs from the corporation, which is based upon a contract between the incorporators and the state.

Since the partnership is merely an association of persons, no separate legal entity or fictitious person is created, as when a corporation is organized; most of the characteristics of the partnership as distinguished from the corporation arise from this simple fact. Consequently the partners are liable for the debts of the business, and the partnership is dissolved when a partner withdraws or a new partner enters. A partner cannot sue the partnership, though he

can sue the other partners; if he could sue the partnership, he would be both plaintiff and defendant at the same time.

The partnership agreement may be oral or written. All that is necessary to establish a partnership is the intention of the participants to enter into the partnership relation. The agreement should be written, for if it is not written, misunderstandings may arise to cause serious disputes. If the agreement is in writing, each partner can see just what his rights and duties are to be, and the terms are more likely to be worked out to the best interests of all. Written agreements are usually more definite and more detailed than oral agreements. Moreover, if one partner should dislike some arrangement made by oral agreement, it would be more difficult to secure his compliance with it.

The reason why partnership agreements are not always written is that the partners trust each other, and each may hesitate to urge a written agreement for fear that his motives may be misunderstood. Indeed, if the partners do not have the utmost confidence in each other's ability, integrity, and fairness, they should not enter into the intimate relationship of partners, for each partner virtually places his fortune and his future in the hands of the others. It has been truly said that one should exercise as much care in choosing a partner as in choosing a wife. The least that should be done, however, is to reduce the agreement to writing.

The partnership agreement should cover the following points:

1. *The name of the partnership.*

2. *The nature of the business to be transacted.*

3. *The principal place of business.*

4. *The capital to be invested by each partner.* If any partner is to invest property instead of cash, a description of the property and the value to be placed upon it should be included.

5. *The salary allowances of the partners, if any.* If any partner is to devote less than full time to the business while other partners devote their entire time, the nature of the arrangement should be described.

6. *The salary or drawings to be allowed each partner.*

7. *Interest to be allowed on capital and charged on drawings, if any.* No interest is allowed or charged unless provided for by agreement.

8. *Methods of increasing capital.* It may be desired to reinvest

either a certain percentage of the profits each year or varying amounts, to be determined by a vote of the partners.

9. *The method of dividing profits.*

10. *The division of authority among the partners.* Thus, one partner might act as cashier, another as sales manager, and so on. Such a provision would not be binding upon outsiders if one partner exceeded his authority in acting for the firm, unless the outsider knew of the terms of the agreement; but it would be binding upon the partners themselves.

11. *The period of time the partnership is to last.* This might be stated in terms of years or in terms of accomplishment. Thus, a partnership for subdividing real estate might last only until all of the lots were sold.

12. *The method of liquidation of the partnership.* The rights of creditors could not be altered by an agreement between the partners, but the agreement should provide for the valuation and disposition of the goodwill and other assets. In a seasonal business it might be desirable, in the event of the death of a partner, to postpone the closing of the books to the end of the fiscal year. The provisions for sharing interest and profits in such cases should be clearly indicated.

The partnership agreement may be implied. If the partners make an agreement for the sharing of profits, or make other agreements from which an intention to enter into the partnership relation might be inferred, they may be held to have formed a partnership by implication. If one person represents to the public that a partnership exists between himself and another, and the second person fails to deny that it does exist, the second person may not be permitted later to deny that he is a partner. In legal terms, he is estopped to deny the partnership, and a partnership is said to be formed by estoppel. Before such a person is held to be a partner, however, it must be shown, first, that the person dealing with the firm had a reasonable right to believe that the person he seeks to hold was a member of the firm; second, that the granting of credit was to some extent influenced by this belief; and third, that the representation of the partnership relation was made on the authority or with the knowledge of the party sought to be held.[3]

A partnership by estoppel would be formed if a father allowed

[3] Brocato *v.* Serio, 196 Atl. 125 (Md. 1938).

his son to use his name in the business in order that he might obtain credit for merchandise or bank loans. Even though the father supplied no capital and received none of the profits, he could be held for the losses of creditors. Likewise, if a partner withdrew from a business but allowed his former partners to continue to use his name on firm letterheads or otherwise, he could be held for debts contracted after his withdrawal. A person who had never been a member of a partnership might be held as a partner if he jestingly spoke of his partner in a card game in such a manner as to mislead creditors into believing that he meant a partner in business.

There are several tests of the existence of a partnership. The question of whether a partnership exists arises when the business gets into financial difficulties and creditors sue the participants in an attempt to hold them as partners. In such cases the testimony of the members that a partnership does or does not exist is not sufficient: the nature of the relationship itself must be examined. What, then, determines whether or not a partnership really exists? Four tests may be applied.

The first test is whether the person sought to be held as a partner shares in the profits. If anyone shares in the profits and losses of a business, he becomes a partner. The difficulty arises where one agrees to participate in the profits but makes no provision for sharing in the losses. In such cases, sharing in the profits is evidence of the existence of a partnership; but it is not conclusive, for there are a number of circumstances under which one might participate in the profits without being a partner. Some of these are as follows: (1) The wages of an employee may be stated as a percentage of the profits: it is quite common to allow managers of important departments or branches a salary and a percentage of the profits; or, the only compensation may be a percentage of the profits. (2) The interest on a loan may be deferred if the business has losses; thus the rate of interest may vary with the amount of profits without creating the partnership relation. (3) The payments to the widow or other representative of a former partner may be made to vary with the profits of the business. (In none of these cases does the agreement to receive payments varying with the profits create in itself the partnership relation.)

A second test is whether the association in the business is voluntary. If the member in question did not enter into the relationship of his own accord, he cannot be held as a partner. Thus, if property is left to children by a will, the property to be kept in trust and

managed for them until a certain time, they cannot be held as partners. Or if the owner of a mercantile business transfers it to his father to be conducted for the joint benefit of himself, his brothers, and his father, a partnership relation does not exist. The brothers, as beneficiaries, would not be liable for the debts of the business, although they shared in the profits.[4]

A third test is whether the business is being carried on in common. This means that if a person takes an active part in the management of a business, he may be held to have been acting as a partner. While this test is important, it is not always conclusive. For example, if a miller agrees to operate the mill of another for a share of the profits, or if a farmer agrees to cultivate another's farm for a share of the crop, a partnership relation does not necessarily exist.

A fourth test is whether the business is carried on for profit. Societies and clubs of a social or religious nature, musical societies, temperance societies, and professional or social fraternities are not partnerships, because they are not conducted for profit.

The partnership may be conducted in the name of the partners or under some abstract name. It is not necessary to use the names of all of the partners in the partnership name, and the business may be designated as a company. It may even be given some name in which the names of the partners do not appear. In some states a partnership conducting business under an impersonal name is required to file with the secretary of state and the recorder of deeds of the county a statement indicating the names of the partners and the interest of each in the business.

Each partner has authority to act as agent for the firm. If nothing is said in the partnership agreement about the power of the partners to act as agents for the firm, each partner receives such power by virtue of the formation of the partnership. The right of a partner to make contracts, legally designated as the power of general agency, may be restricted by a provision in the partnership agreement. Despite such a limitation, the partnership will be bound by contracts made by any partner unless the outsider had been previously informed that the partner had no authority to make the contract. However, a partner who makes contracts for the partnership in violation of an agreement with the other partners is himself liable for breach of contract.

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[4] Connaly *v.* Lyons, 82 Tex. 664 (1891).

The power of the partner to act as agent for the firm and to make contracts in its name is limited to matters relating to the partnership. Specifically, a partner may act as agent for the firm in making contracts covering the following:

1. *The employment of sales persons, office help, or persons to act in other capacities for the firm.*

2. *The collection of debts due* to *the partnership.* A partner may also bring suit for the collection of debts in the name of the firm. Receipts given by one partner for money collected on partnership debts are binding upon the firm.

3. *The purchase of merchandise or equipment for the partnership.*

4. *The sale of merchandise or equipment.* A partner can transfer title to partnership property, except real estate, which can be conveyed only by the one having title to it.

5. *Guarantee of the product, if necessary to make a sale.*

6. *The borrowing of money and the pledging of the property of the firm.* If, however, the partnership is a professional partnership which usually does not need to borrow money in conducting its ordinary operations, such as a firm of physicians or accountants, the consent of all the partners must be obtained before the partnership can be held liable for repayment.

When a partner makes contracts for the firm, he should sign in his capacity as a representative of the firm in a form similar to the following:

John Smith and Company
By John Jones, Member of the Firm

A signature by a partner without some indication that he is acting for the partnership raises a strong presumption that he is making the contract for himself alone and for which he alone is to be held. To overcome such a presumption, there must be something in the agreement or in the nature of the transaction to which it relates, to indicate that it is a partnership undertaking.

Each partner may make the partnership liable for damages. If a partner in performing the business of the partnership inflicts injuries upon the person or property of another, the partnership is liable. For example, if a partner on business for the partnership runs his automobile into the automobile of another person, the

partnership is liable. The partnership is also liable for false and damaging statements made by any partner about a competitor. And the same is true if a partner in securing a loan from a bank makes false representations of the financial standing of the firm.

If the injury inflicted upon another is not done in the course of partnership affairs, the partner alone is liable. This rule is obviously proper, though in fact it is often difficult to apply it to concrete situations.

The partners have certain obligations to the firm. In view of the large powers which the partners have to bind the partnership in making contracts and to render the partnership liable for damages, it is to be expected that the partner should have important obligations to the partnership. In general, the partner is required to be loyal to the firm and to do nothing that would hinder its business. More specifically, the following duties of each partner may be distinguished:

1. Each partner should use his time and his energies for the interests of the firm. He cannot enter another business that would compete with it. If he should violate his obligations by setting up a competing business, he may be required to account for any profits made and to pay the profits into the partnership. However, a partner may engage in a noncompeting business if he is not expressly required by the partnership agreement to devote his entire time to the affairs of the partnership. In the absence of a contrary agreement, moreover, if one partner devotes less than his full time to the partnership, he is entitled to as large a share of the profits as if he had devoted his entire time to the business.

2. Each partner is obliged to use good faith in all partnership transactions. He must not misrepresent any transaction and must not conceal any partnership affairs from the other partners. Misconduct in business affairs is sufficient ground for the dissolution of the partnership. And this duty applies even to the negotiations for the formation of the partnership. If, for example, one of the prospective partners proposes to contribute a piece of land and a building as his share of the capital, he is required to disclose all the facts relating to the cost of the property and its condition. If he does not do so, he is guilty of a violation of the good faith which is required of him. The deceived partner may cancel the agreement and is entitled to a return of his contribution to the partnership.

3. Each partner is required to contribute his share of the ex-

penses of the firm. If the property of the firm is not sufficient to pay the expenses, each partner is required to contribute his share. This is an obligation arising from the partnership relation, and the partner is not entitled to any remuneration from the other partners for his contribution.

Each partner has certain rights. The most important of the rights of the partner are as follows:

1. Each partner is entitled to a share of the profits.
2. Each partner has a right to be informed about partnership affairs and to inspect all of the records of the partnership. Nothing pertaining to partnership affairs is to be kept secret from any partner. He may inspect the books at any time.
3. If loans are made to the partnership, the partner is entitled to interest on them. However, no interest is allowed on capital or charged on drawings unless provision is made for it in the agreement.
4. A partner who incurs expenses in conducting the affairs of the partnership or in protecting its property is entitled to reimbursement. As noted in the preceding section, each partner is required to contribute his share of such expenses.
5. Each partner is entitled to a share in the management. Ordinary affairs of the business are decided by a majority vote, each partner having one vote. This is true, for example, of decisions concerning the purchase of merchandise or equipment, for the deposit of money in a bank, for the borrowing of money on a mortgage of firm property or otherwise, or for the adoption of a certain system of accounts. As pointed out earlier, however, each partner has the power to make contracts relating to such matters, and the partners may themselves agree to leave certain activities to certain of the partners without requiring that decisions be made by all the partners.

Some questions relating to the fundamental policies of the partnership may be decided only by the unanimous consent of the partners. Thus, a proposal for an expansion of the business into new lines, or for dropping important divisions of the business, would require unanimous consent. The admission of a new partner and the sale of all the assets also require unanimous consent.

Partnership profits may be divided in any one of several ways. Unless provision is made in the partnership agreement for the

method of dividing profits, it is presumed that all members are to share equally. The reason for equal division is that contributions of capital, time, and ability or experience are assumed in the aggregate to be equal unless the partners agree otherwise. Some of the possible methods of dividing profits are as follows:

1. In the ratio of capital invested when the partnership was organized.

2. In the ratio of capital at the beginning or end of each year, after allowing for drawings and additional contributions.

3. In the ratio of average capital investments for the year.

4. Allowances of salaries to partners, with the balance of the profits divided equally or on some other basis. If profits are less than the salary allowances, salaries are paid nevertheless, and the resulting loss is distributed in the ratio agreed upon for the sharing of the balance of the profits.

5. Allowances of interest on capital invested in the business, and the balance divided in an agreed ratio. As in the case of salaries, the interest is allowed regardless of whether profits are sufficient to cover the amount.

6. Allowances of both interest and salaries, with the balance divided in an agreed ratio.

7. In an arbitrary ratio without reference to capital or time devoted to the business, as forty per cent and sixty per cent.

A partner may be entitled to an accounting. To render an accounting is to inform each partner of: the financial condition of the partnership; the amount of the profits or losses to date and the share of each partner; and the amount of the original capital contribution of each partner, plus his share of the profits and contributions of capital since organization, less drawings made and less his share of the losses, if any. Some of the circumstances under which a partner is entitled to an accounting are the following:

1. When a partner has been wrongfully excluded from the partnership business or the possession of its property by the other partners.

2. When one partner wrongfully derives profits for himself from the business or by the use of its property.

3. When the interest of one partner in the business has been

attached by his personal creditors in settlement of debts due them.

4. When other circumstances render an accounting just and reasonable.

There may be several classes of partners. In the preceding discussion it has been assumed that all partners have the same rights and duties and exercise the same responsibility in management. However, this is not always the case, since the partners may by agreement alter their relationship to each other.

General partners are those who share in the management. Their connection with the firm is known to persons doing business with the partnership, and to the public generally. Such partners are sometimes spoken of as *active partners.*

Secret partners are those whose connection with the firm is not known to the public. They share in the management.

Dormant partners have no share in the management, and their relation to the business is not known to outsiders. Thus, dormant partners are both inactive and secret. If the dormant partner withdraws from the partnership, he is not required to give public notice of his withdrawal, since his relation to the partnership was not previously known.

Nominal partners are those who have permitted others to believe that they are partners. They are not partners by agreement but by virtue of their being held out or represented to the public as being partners. If, for example, a partner withdraws from a firm but gives no notice to creditors or others of his withdrawal, and permits his name to be used on letterheads of the business after his withdrawal, he might be held liable for partnership debts as a nominal partner. Such partners are sometimes called *ostensible partners.*

III. The Dissolution and Liquidation of the Partnership

The dissolution of the partnership must be distinguished from the liquidation of partnership affairs. *The dissolution of the partnership is the termination of the original partnership agreement.* A new agreement may be made, with the same partners participating or with one or more new partners being admitted. If the business is liquidated, however, the assets are sold, the liabilities are paid, and the balance is distributed among the partners. A partnership may be terminated or dissolved without interference with the usual business transactions.

Many factors may cause a dissolution of the partnership. Since the partnership is based upon a personal contract between the partners, anything which changes the contract relation results in its dissolution. It is dissolved by the withdrawal of a partner, the admission of a new partner, or the sale of the interest of one partner to an incoming partner. The partners may also agree at any time to dissolve the partnership and to liquidate its affairs. If they originally agreed to continue the partnership for a certain period of time, the partnership is automatically terminated at the end of that time. Even where it is agreed that the partnership is to continue for a certain period, a partner can withdraw at any time he chooses, for there is no such thing as an indissoluble partnership.[5] The withdrawing partner would be liable for damages to the other partners if they could establish the facts that the partnership agreement had been violated and that they had suffered injury as a result of the breach of contract.

Many events not under the control of the partners may result in the dissolution of the partnership. If the partners are citizens of different countries and those countries declare war upon each other, the partnership is dissolved: the obligations of the partners to their respective countries in wartime would prevent them from performing their duties to each other. The death or insanity of a partner dissolves the firm, as also does the passing of a law which makes the object of the partnership illegal. A contract for the accomplishing of an illegal purpose is never enforceable, such as a partnership for restraining trade, for highway robbery, or for kidnaping. Still another occurrence which brings the partnership to an end is the bankruptcy of a partner: a partner who is bankrupt is not able to meet his obligations to the partnership, and the other partners are therefore relieved of their obligations.

A partner may cause the dissolution of the firm, even though the term of years during which the partnership was to endure has not elapsed, if he can prove to a court of law that the continuation of the partnership would be inadvisable. Some of the circumstances under which a court might order a dissolution of the partnership are fraud, practiced by one partner upon the others, or quarrels among the partners which would prevent the smooth conduct of the business. The causes of the dissolution of the partnership may be summarized as follows:

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[5] Solomon *v.* Hollander, 55 Mich. 256, 21 N.W. 336 (1884).

Causes of Dissolution of the Partnership

I. Dissolution by acts of the parties.
   - A. Dissolution by provisions of original agreement.
     1. Lapse of time agreed upon.
     2. Accomplishment of object of the partnership.
     3. Happening of some event or condition.
   - B. Dissolution by subsequent acts of the parties.
     1. Mutual consent.
     2. Admission of a partner.
     3. Withdrawal of a partner.
     4. Expulsion of a partner.
     5. Incorporation of the business by mutual consent.

II. Dissolution by the happening of certain events.
   - A. Death of a partner.
   - B. War between the countries of which partners are citizens.
   - C. Insanity of a partner.
   - D. Illegality of the object or business of the partnership.
   - E. Bankruptcy of a partner or assignment of property for benefit of creditors.
   - F. Formerly, the marriage of a female partner.

III. Dissolution by judicial decree.
   - A. Fraud in the creation of a partnership.
   - B. Incapacity of a partner.
   - C. Misconduct of a partner.
   - D. Irreconcilable discord.
   - E. Impossibility of success.

Since the partnership is dissolved by so many causes and events, most partnerships are not of long duration—though a business may be operated without interruption by a series of partnerships. The partnership really has greater stability than the list of causes of dissolution might seem to indicate.

Partnerships may be terminated by conversion into corporations. The history of successful businesses often is that of growth from single proprietorships, to partnerships, to corporations. When a partnership is changed to a corporation, the partners usually revalue the properties owned by the business in order to place them on the books at current market values. The partners credit themselves, in the ratio in which they share profits, for the increased value of the assets. In legal fiction they then sell the properties to the corporation which is being formed, and the corporation assumes

the liabilities of the partnership. Payment for the net assets of the partnership is made in stock, and the stock is transferred to the partners. A similar procedure is followed in case of the consolidation of a number of businesses.

The obligations of a partnership which is being liquidated must be paid in a certain order. When the properties of a business are sold and the liabilities and capital accounts are liquidated, the first payments must be made to outside creditors. Here the usual preferences must be recognized, preferred claims for taxes and court costs being paid first, secured claims such as chattel and real-estate mortgages second, and unsecured claims such as accounts and unsecured promissory notes third. After all outside creditors have been paid, the obligations to partners are paid. Loans from partners together with interest are paid first, and then the original capital contributions are returned; the remaining assets, if any, represent profits and are distributed to the partners in the ratio in which they share profits and losses. If the cash or property is not sufficient to repay the original capital of the partners, the deficiency represents the losses of the business. These are charged against the partners in the profit-and-loss ratio, and the share of each partner in the loss is deducted from his original capital contribution. The remaining balance is the amount to be paid to each partner.

If the partnership property is not sufficient to pay the debts, the creditors may take action against the partners. If some one partner has sufficient property, the creditors may recover the entire amount from him. However, he would be entitled to be reimbursed by the other partners in an amount sufficient to cover their share of the losses. Some authorities state that creditors may proceed against the property of the partners at once without first proceeding against the property of the partnership. Others contend that the assets of the partnership must be exhausted before action can be taken against the property of the partners.

Partnership property is first applied to the payment of partnership debts, individual property to individual debts. If both the partnership and one or more partners are bankrupt, the partnership creditors have a prior claim upon the assets of the partnership. If a partner's property outside the business is not sufficient to pay his debts, his outside creditors have the prior claim. After the outside creditors have been paid in full, the creditors of the partnership may satisfy their claims from whatever property remains. Similarly, if outside creditors have exhausted the outside assets of a

partner, they may proceed against the assets of the partnership. They are entitled to whatever investment the partner has after the partnership debts have been paid.

IV. Special Forms of the Partnership

The special forms of the partnership to be discussed in the present chapter are the *joint venture* and the *limited partnership.* In addition to these forms, the *joint stock company* is often considered a form of the partnership. The joint stock company has so many peculiar features that it seems best to defer the discussion of it to a later chapter.

The joint venture is a temporary partnership arrangement for a single undertaking. The joint venture or, as it is sometimes called, the "joint adventure," is organized for a limited purpose, usually for undertakings which are more speculative than ordinary business transactions. The venture is usually managed by one of the participants, but it is not necessary that one of them accompany the shipment of merchandise. All of the participants usually contribute a part of the capital, although this is not always the case. In the early shipping ventures it was quite common for the member who remained at home to furnish all of the capital. As ocean shipping has become less risky, the use of the joint venture in foreign trade has become less common, but it is often used in other lines of activity. One common form of the joint venture is the stock pool.

The resemblance of the joint venture to the general partnership can be seen from the following requirements of the joint venture:

1. Intent of the parties to associate themselves as such.

2. A contract, which may be oral, written or inferred from the conduct of the members or from facts or circumstances which make it appear that a joint enterprise has been entered into.

3. The use of the combined property, money, efforts, skill, or knowledge of the members in a common undertaking.

4. Joint proprietorship and control over the subject matter or property of the undertaking.

5. An agreement, express or implied, for the sharing of profits.[6]

The joint venture differs from the ordinary partnership in that the extensive operation or conduct of a business is not contem-

[6] Rae *v.* Cameron, 114 Pac. (2d) 1060 (Mont., 1941).

plated; it resembles the ordinary partnership in that the relation of the participants to each other is determined by contract. The member of a joint venture has no power to incur debts or other obligations which bind the other participants, except as he is expressly authorized to do so. In many ventures only a few contracts need to be made, and these are expressly approved by all of the participants. In any case, the number of contracts is not large, and it is not usually necessary to confer general powers of agency upon any of the members. In matters which are strictly within the scope of the venture, however, any member can make contracts for the other adventurers provided their names are made known. Property needed for the venture is held, by one or more of the associates, in trust for the benefit of all, as in an ordinary partnership. The joint venture usually terminates without any formalities when the purpose has been accomplished or the time agreed upon has elapsed. A member is not permitted to withdraw before the venture has been completed unless he can show good reason for doing so. If a member dies, the venture is completed by the other participants and the share of the deceased member is paid to his estate. In some states corporations may participate in joint ventures but not in partnerships.

The joint venture has in some states been construed to include an arrangement between two or more persons for transportation by automobile where one furnishes the car and the others pay all or a part of the expenses of the trip. The courts have held this kind of arrangement to be a joint venture for transportation of persons; and they have fixed upon the driver, who is one of the co-adventurers, the liability in damages if, as a result of his carelessness, an accident occurs and the passengers in his car are injured. In entering upon such a venture, the courts say, the driver assumes the duty to exercise care during the trip for the safety of his co-adventurers.[7]

The extension of the idea of the joint venture to include an agreement for the transportation of persons by automobile is illogical; and it can be explained only by the fact that the courts are anxious to find a reason for holding the driver responsible for his carelessness. The contract provides for only one trip extending over a limited period of time, but the purpose of the journey is not the making of profits. No merchandise or service is to be sold at the destination. The parties to the contract have as their only common

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[7] Manos *v.* James, 110 Pac. (2d) 887 (Wash., 1940); also Rae *v.* Cameron, 114 Pac. (2d) 1060 (Mont., 1941).

objective the reaching of a designated place where each will pursue his own purposes. While the driver should be held accountable for his carelessness, the decision should be based upon some other legal principle or analogy.

Limited partnerships can be formed only when provision for their organization is made by law. Limited partnerships, in which the liability of some but not all of the partners is limited to the amount of capital paid in, are said to have been legalized in certain Italian cities as early as 1160. The Mediterranean trade of the Middle Ages, as noted earlier in this chapter, was carried on largely by the *commenda,* which was a form of partnership for sea trading in which the liability of some of the members was limited. From Italy the limited partnership was introduced into France and other countries of western Europe. It was regulated by Louis XIV of France in 1673.[8] The French in turn introduced it into their colony of Louisiana, from which it was copied by the other states of the Union. A statute authorizing its formation was passed by New York in 1822, and it was adopted soon afterward by Maryland, Massachusetts, Rhode Island, and New Jersey. At the present time most, though not all, states have passed laws providing for its formation. In states which have not authorized its formation, the limited partnership is treated as a general partnership and all partners are held to unlimited liability.

The nature of the limited partnership. There must be at least one partner whose liability is unlimited, but the liability of the other partners may be limited. The names of the special or limited partners cannot be used in the firm name, and the limited partners cannot take any part in the management of the business. If they are employed in any way as agents or attorneys for the partnership, they may be liable as general partners. They may, however, keep themselves informed about the affairs of the partnership by examining its accounts and in other ways, and they may advise as to its management. In other respects, such as dissolution, the rights and duties of the partners, and the rights of creditors, the limited partnership is like a general partnership.

Method of formation. The method of formation of the limited partnership is prescribed by statute. Under the New York law the partnership files with the clerk of every county in which it maintains a place of business a certificate setting forth the names and

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[8] R. R. Formoy: *The Historical Foundations of the Modern Company,* p. 44. Sweet and Maxwell, Ltd., London, 1923.

addresses of all of the partners, both limited and general, and the amount of capital furnished by each. Other information such as the name of the partnership, the nature of the business to be conducted, and the period of time the partnership is to exist, must also be given. To secure the advantages of the act, the provisions of the law must be complied with in every detail. A failure to comply with the law does not render the contracts of the partnership void, but it causes the partners to be held liable as general partners.[9]

V. Evaluation of the Partnership

In the last one hundred years, and particularly in the last fifty years, the partnership has declined in importance and its place has been taken by the corporation. The emphasis which has been placed upon the advantages of the corporation might lead one to think that the partnership offers no advantages, but the partnership has many advantages over the corporation and the single proprietorship as well, from both the personal and the social points of view.

The partnership offers many advantages to the business man as a form of organization. As compared with the single proprietorship, the principal advantages are as follows:

1. The partnership is in a better position to raise capital. The fact that partners may be admitted makes it possible to operate the business upon a larger scale and to secure some of the economies of large businesses. The profits may be more than doubled if the capital is doubled by the admission of a partner.

2. The partnership permits of specialization in management, whereas a single proprietor must manage or supervise all of the activities of the business, as buying, selling, public relations, financing, and bookkeeping. It is seldom that one person is able to manage efficiently all of these activities.

3. The partnership affords an opportunity for the discussion of business problems. Even though two persons are equally proficient, each may gain much from consultation with the other.

As compared with the corporation, the partnership has the following advantages:

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[9] For further discussion, see "Limited Partnership," *Yale Law Journal,* March, 1936, Vol. 45, pp. 895-907.

1. It is easy and inexpensive to organize. It is formed merely by the drawing up of an agreement between the partners. There are no legal requirements, and no taxes other than the usual license taxes required of all businesses.

2. The partnership enjoys a strong credit position. Since the partners are liable for the debts of the partnership, their entire property is security for its obligations; and the partnership can often borrow on better terms than can a corporation.

3. Partnership taxes are relatively small. The partnership pays no income tax and no franchise taxes, and is free from many expenses to which corporations are subject, such as the expense of stockholders' and directors' meetings and taxes on the transfer of stocks. Partnership property is subject only to the property tax, whereas both corporate stock and corporate property may be taxed. If a partnership wishes to enter another state to do business, it may freely cross state boundary lines without legal formalities or fees.

4. The partnership offers flexibility in management. Decisions may be made informally by the partners by majority vote. The partners may include any arrangement they like in the partnership agreement. They are not required to share profits in the ratio of capital contributions or to meet any other formal requirements.

5. Each partner is assured of a voice in the management of the business. Since each partner has a vote in deciding management problems, each must be consulted. And in matters requiring unanimous consent, each partner has a veto of proposals. This situation may be contrasted with that of the corporation, in which the management is intrusted to directors who are elected by majority vote. The minority often has no representation on the board of directors and therefore no voice in management.

6. The partnership offers greater inducement to the members to work for the business. This is due to the fact that there are usually only a few partners and that each has a direct voice in the management. Andrew Carnegie contended that partnerships were likely to be much better managed than corporations. As he said, "You take thirty-five young men interested in watching every leak in a spigot and no corporation can compete with such an organization in any business." The Carnegie enterprises, however, were finally incorporated while under Mr. Carnegie's control. A corporation with only a few stockholders may be able to secure almost, if not quite so much, loyalty from its members as a partnership can.

The partnership has many disadvantages. The disadvantages of the partnership as compared with the single proprietorship are as follows:

1. The profits must be shared with the other partner or partners. If the volume of business and the profits cannot be increased as additional partners are admitted, the share of each is decreased.

2. The management is shared with the other partners. If an individual proprietorship is changed to a partnership, the original proprietor loses a part of the control over his business.

3. Secrecy of business affairs becomes more difficult.

4. The risk of choosing dishonest or incompetent partners is a great weakness of the partnership.

As compared with the corporation, the partnership has the following disadvantages:

1. It has limited life. The fact that the partnership is terminated with each change in its membership gives it an element of instability which may interfere seriously with its financial and business planning. Partnerships and single proprietorships are often discriminated against in the leasing of properties for this reason.

2. It cannot raise large amounts of capital so easily as a corporation. Necessarily, with a large number of partners, the changes in membership are likely to be so frequent as to be confusing. Since the partnership carries unlimited liability, no person can afford to have an interest in a great many partnerships because the failure of any one of them might cause him to lose everything. With partnerships, therefore, the safe rule for the partner is not to diversify but to place all of his interests in one business. Consequently the partnership cannot appeal to the great ranks of small investors in raising its capital.

3. The unlimited liability of the partners constitutes a serious personal objection to the partnership. This is the reason so many small businesses incorporate.

4. The fact that every partner is an agent for the partnership increases the risk. No matter how carefully one selects his partners, there is always the danger that a partner may prove incompetent or dishonest.

5. It is difficult to withdraw an investment from a partnership.

If a partner wishes to withdraw, he must find a purchaser who is acceptable to the other partners. Usually he must sell either his entire interest or none. If the entering partner is required to assume a share in the active management, the difficulty of finding a buyer may be increased. In some cases the interest of the withdrawing partner may have to be transferred at a considerable sacrifice.

6. The lack of centralized authority may handicap the partnership: the necessity for conferences delays decisions, and if the partners are not entirely in agreement upon policies, their difficulties may be intensified by the lack of a centralized organization.

Questions

1. Describe the temporary partnership arrangement known as a *commenda*.
2. What features of the early partnership were similar to the family relationship?
3. In what lines of business activity is the partnership still important?
4. What are the characteristics of the fields of business activity where the partnership is important?
5. Why should businesses which began as partnerships be changed to corporations?
6. What are the tests of whether an enterprise is organized as a partnership?
7. If two persons entering into a partnership relation trust each other, why is it advisable to make a written agreement?
8. What should be included in the partnership agreement?
9. What is a partnership by estoppel?
10. Does a person necessarily make a capital contribution in becoming a partner?
11. Does the sharing of profits make a person a partner? Can a corporation use a profit-sharing plan which permits officers or employees to participate in profits?
12. Can a partnership use the word company as a part of its name? Can it use the word corporation?
13. To what extent can a partner make contracts that are binding upon the firm? Give examples.
14. What precautions should a partner observe in signing contracts for the firm?
15. What are the duties of a partner?
16. Is a partner entitled to interest on his capital invested in the business? Is he entitled to interest on his loans to the firm?

17. What questions relating to partnership affairs require unanimous consent of the partners? What questions are decided by majority vote? Give examples.

18. Name the ways of dividing profits in a partnership. Indicate circumstances where each might be used.

19. What is meant by rendering an accounting? Would it be desirable to render an accounting at the end of each year?

20. Why should secret partners and dormant partners be liable for debts when their relations to the business are not known to creditors? Do they owe an obligation to the other partners to bear their share of the losses?

21. Distinguish between termination of the partnership and dissolution of the business?

22. Can a partner terminate the arrangement at any time? If so, why does the partnership agreement sometimes state that the partnership is to continue only for a limited time?

23. Why should the insanity or the bankruptcy of a partner bring the partnership to an end?

24. Show how the partnership is more flexible than the corporation.

25. In what order are the obligations of a partnership paid at the dissolution of a business?

26. How does the joint venture differ from the general partnership? Does it make any difference whether an enterprise is a general partnership or a joint venture?

27. Give examples of joint ventures.

28. What is the similarity of an agreement for the transportation of persons by automobile to the usual joint venture? What is the difference between the two types of agreement?

29. What country introduced the limited partnership into North America? Through what state?

30. How is a limited partnership formed?

31. How does a limited partnership differ from a general partnership? Why should at least one member of the firm be liable as a general partner?

32. Suppose that after *A* and *B* entered into a partnership agreement, *A* learned that *B* was incompetent, what could *A* do?

33. If *A* could change the form of organization to a corporation (Question 32), how would the relationship of the members be changed?

34. If *A* found that *B* was dishonest, would his position be any different (Question 32)?

35. Compare the partnership with the single proprietorship as a form of business organization for small enterprises.

36. Compare the partnership with the corporation as a form of organization for small enterprises.

CHAPTER IV

The Joint Stock Company

The joint stock company is *an unincorporated company in which numerous members hold transferable shares.* It resembles an ordinary partnership in that unlimited liability for its debts rests upon its members. It differs from the partnership in that its shares are freely transferable without termination of the life of the company, and the death, insolvency, or insanity of a member does not dissolve it.

The joint stock company developed as a common-law organization without specific grant of authority from the state, and it is now so well established that specific authorization is not necessary for its organization. In fact, however, many of the early joint stock companies received charters from either the Crown or Parliament, and at the present time they are generally regulated by law. This type of company deserves our study, because of its present use as a form of business organization, and also because it constitutes an important step in the historical development of the corporation.

I. The Joint Stock Company in England

The joint stock company was at one time the most important form of business organization for large-scale enterprises. It was the predominant type of business enterprise during the sixteenth and seventeenth centuries when England was assuming a leading role in the commercial affairs of Europe, particularly during the period when a large percentage of the investment capital of various European countries was being advanced for exploring, colonizing, and trading ventures. Many of these enterprises were organized as joint stock companies.

The idea of the joint stock company was first developed in Italy. The first companies of this nature were organized in Italy during the fourteenth century in order to render financial assistance to certain of the city states. Genoa had incurred a debt in the con-

quest of some of its colonies, and when it was unable to pay the debt it turned the colonies themselves over to the creditors for administration. The debt was divided into transferable shares, and the company thus organized had the right to trade in the colonies and to develop their public works. In 1407 the Bank of Genoa agreed to assume the existing debt of the city of Genoa in return for the privilege of engaging in the banking business. The holders of the bonds of the city surrendered them in exchange for stock in the bank. Thus the city was relieved of the debt while the holders of the stock received valuable banking privileges. In 1453 the Bank of Genoa became a colonial trading company and thus received from the city the right to control the trade and commerce of its colonial possessions.[1]

The joint stock company developed in England at a later period. Just how much influence the Italian companies exerted upon the development of similar companies in England cannot be determined with certainty. Many persons believe that their influence was not great. When English joint stock companies were being organized, the Italian cities were declining in importance and their relations with England were not close. The germ of the joint stock company may be found in two English institutions, the guild and the partnership.

The joint stock company was a development from the craft guild. The craft guilds were associations of artisans which flourished in England for about three centuries beginning some time after 1100. Members of each craft, such as stone-cutters, weavers, goldsmiths, blacksmiths, and cabinet makers procured a royal grant organizing them for mutual protection and conferring upon them the exclusive right to practice and also to regulate the trade. Each guild was authorized to supervise the quality of wares produced and to require honest workmanship. It also regulated the hours of labor and the terms of admission to the trade, including the number of apprentices that could be accepted, the length of the period of apprenticeship, and the character of the training to be given. It provided for the display of merchandise at fairs and markets, inspected weights and measures used by traders, and prohibited corners on the supply of the product.

There are many points of resemblance between the guild and the joint stock company. Both had continuous existence, which made

[1] W. S. Holdsworth: *A History of English Law,* Vol. VIII, p. 208. Little, Brown. and Co., Boston, 1926.

possible the ownership of property and the transmission of rights from one group of persons and even from one generation to another. The permanent existence of the guilds was definitely implied in the grant of property to it "to possess now and henceforth" and the organization of certain guild societies "evermore to lasten." Moreover, the guild had a common seal which seemed to identify the act as being that of the whole body and not of separate individuals.

In organization the guilds had many points of resemblance to the early joint stock companies. Each guild elected an alderman to administer its affairs, and one or more wardens or stewards to manage its property. Reports were rendered to the members concerning the progress of its affairs, particularly of the loan funds, and the accounts of some of the guilds were regularly audited.[2] The guilds also framed their own by-laws, in which the privileges of the members were stated; this feature was later copied by both joint stock companies and corporations.

Joint stock companies were organized in England for foreign trade. The need of the state for business organization was not, as in Italy, for a company to lend money to the government, but for companies to foster and organize foreign trade and later to found and administer colonies. The kings of England found it difficult to punish traders in distant lands who were guilty of crime; it was also difficult to protect them from the crimes of others. Transportation and communication were slow, and the navy was not strong enough to police the seas. Consequently it was in the interest of the king to grant a monopoly of the trade in each country to a company which could maintain law and order, regulate the relations of traders with the nationals of the foreign government, and build up the export trade. It was also easier for the king to regulate and control the affairs of a single company than to control the affairs of a number of individuals.

The traders were anxious to receive charters. An association of traders, organized without authority from the Crown, was generally looked upon with suspicion. Moreover, the charters granted important powers of self-government, particularly the power to impose taxes and to settle disputes. The monopoly of trade which the charter conferred was a distinct advantage. In some cases the charter granted exemption from certain trade regulations, such as the restrictions upon the importation and exportation of merchan-

[2] For a complete history of the early joint stock companies, see W. R. Scott: *Joint Stock Companies to 1720* (3 vols.). The University Press, Cambridge, 1912.

dise. The large company had important economic advantages over the individual trader: by distributing the risks over many ships and many cargoes, it was able to reduce the risks of loss at sea and on land. It could also secure trading concessions and protection for its members abroad, not only because it was organized to resist encroachments upon the rights of the members, but also because it could divert the entire English trade from any city if it chose to do so.

The earliest companies were regulated companies. The regulated company, from which was to come the joint stock company, had no trading capital of its own, but was merely an association of traders. Each member traded on his own private capital in those sections of the world in which the company had an exclusive right to trade; he took his profits and bore his losses alone. An individual member might, however, associate himself with other members to ship merchandise on joint account. The organization of the regulated company was thus supplemented by groups of members trading as partners or joint adventurers.[3]

The regulated company made its own rules of trading, though frequently the king or Parliament placed restrictions upon its powers. The by-laws usually stated that no one but a member might trade within the territory of the company. In many cases the by-laws stipulated that no member might sell below a standard price and that no member might sell more than a certain quantity each year. The rules of the Turkey Company were particularly burdensome, restricting the trade in the territory of the company to the freemen of London. This company was required, by act of Parliament in the reign of George II, to liberalize its rules.

The regulated companies gradually changed to joint stock companies. While the regulated company rendered valuable service in developing the foreign trade, it was not able to meet the needs of a growing nation except for a short period of time. Adam Smith pointed out that the regulated companies were not able to supply the necessary capital for the development of trade. They were dependent upon entrance fees and occasional assessments, and did not have the capital to build the forts and trading facilities abroad which were required; moreover, the directors did not have a vital interest in the development of the general trade, since, in fact, the decay of the general trade itself might contribute to the advantage

[3] E. Lipson: *Economic History of England,* Vol. II, p. 227. A. and C. Black, Ltd., London, 1931.

of the private trade of the directors.[4] Consequently the regulated companies either changed to joint stock companies with a permanent stock or were disbanded.

The transformation of the regulated company is illustrated by the change in the organization of the East India Company. At first, that company, like all other regulated companies, had no permanent capital: each voyage was financed separately. Each member was free to invest or not to invest in any given venture. Certain fixed properties had to be passed on for the next voyage at an agreed valuation, but for the most part the thing that was permanent was not the capital but the governmental machinery of the company. Later, subscriptions were taken for capital to be used for a few years; the first part of this capital, which was semi-permanent, being subscribed in 1613 for four-year voyages. The company did not have a permanent capital until 1657.

The development of the joint stock company was influenced by the large partnership. The joint stock company is still spoken of by many legal writers as a form of the partnership. It is indeed known that many large partnerships were changed to joint stock companies. As noted in the preceding chapter, the partnership existed in England at least as early as 1284. Its growth was particularly encouraged by the church doctrine, that the charging and taking of interest for money loaned was a sin. Men of wealth, forbidden by the church to take interest, were required to invest their money directly if they were to receive an income from it: thus, in industries which were growing rapidly these partnerships thrived, and there was a tendency to admit additional partners. As partnerships became large and unwieldy, some other form of organization was sought, and the logical development was the joint stock company. In several cases, particularly in mining companies, the transition from the partnership to the joint stock company was made by a grant of a charter to a large partnership.

The early joint stock company differed from the partnership principally in the transferability of its shares. The joint stock companies resembled the large partnership in many respects. Both forms of organization could be formed under the common law. A member of a joint stock company, however, could dispose of a part or the whole of his share in the undertaking without receiving the consent of the other participants. It was principally in this respect

[4] *Wealth of Nations,* Book V, Ch. I.

that the early joint stock companies differed from the large partnership. Shares in joint stock companies were sold freely as early as the sixteenth century.

The joint stock company was the result of gradual evolution. The nature of this evolution may be illustrated by the changing character of the capital stock. The capital of the early companies was divided into a relatively small number of shares: hence, if the business was of any magnitude, the shares were very large, and membership was confined to the wealthier classes. As the needs for capital increased, it was found to be desirable to attract people of moderate means. Two methods of attracting the small investor were used: one method was to divide the shares into fractions, so that the small investor might purchase, say, one-half or one-tenth of a share; the second method was to admit underadventurers, shares being assigned to smaller companies, which in turn assigned their shares to individual investors.[5]

The practice of having shares of a fixed nominal value probably began with the East India Company. Whereas other companies had first fixed the total amount of capital to be raised and the total number of shares, leaving the value of the share to be determined, this company introduced the practice of fixing the nominal value of the share and leaving some latitude in the number of shares to be issued.

The sale of securities to the public eventually led to serious abuses. The era of popularity of joint stock companies culminated in a panic in 1720. Prior to that time, a number of objectionable securities practices developed which seem surprisingly like those of more recent times. The market prices of shares were manipulated, partly through the publication of false or misleading information by promoters. Charters were granted by the Crown conferring powers that were too broad. Control of companies was passed from one management to another without reference to the wishes or interests of the security holders. Many questionable accounting practices were followed, such as failure to make provision for the wear and tear of property and the payment of dividends out of the amounts originally paid in by shareholders rather than from income.

The Bubble Act of 1720 checked the use of the joint stock company as a form of business organization. As a result of the abuses

[5] W. R. Scott: *Op. cit.*, Vol. I, p. 155.

practiced by promoters in forming unincorporated companies, Parliament passed a law in 1720 which is known as the Bubble Act. This law was probably meant to put a stop to certain financial practices, but it definitely checked the use of the joint stock company device as a type of business enterprise. The law declared that the subscribers to various projects which proved to be injurious to the public "have presumed to act as if they were corporate bodies, and have pretended to make their shares transferable or assignable, without any legal authority, either by act of Parliament, or by any charter from the Crown for so doing." It stated that the acting or the presuming to act as a corporate body or bodies, the issuing of transferable shares without the authority of Parliament or the Crown, the acting under a charter for purposes not intended by the original grant of the charter, and the acting under a charter which was obsolete, should be illegal. While the meaning of the law is not entirely clear, it apparently meant that thenceforth the privilege of issuing transferable stock was to belong only to an incorporated company and not to a common-law joint stock company.

The right of a joint stock company formed under common law to issue transferable shares is now admitted. Even under the Bubble Act, it seems that common-law companies had the right to issue transferable shares, provided the companies were not fraudulent or were not otherwise of a dangerous or mischievous character. There were very few prosecutions while the law was in force, and its interpretation was limited to a few cases. About two years after the act was passed, there was one conviction, but the law was not acted upon again for eighty-seven years.[6] From 1808 to 1825 when the Bubble Act was repealed, there were a few prosecutions under the law. It was not until after 1825, however, that the formation of a joint stock company with a transferable stock was finally held to be legal at common law.[7]

The great trading and colonizing companies gradually declined. The joint stock companies of the seventeenth century greatly influenced the economic and political development of Europe. They brought in new goods from abroad; they provided important outlets for the manufactures of Europe; and they stimulated the growth of capital. Politically their colonizing activities were very sig-

[6] E. H. Warren: *Corporate Advantages Without Incorporation,* p. 330. Baker, Voorhis, and Co., New York, 1929.

[7] For a discussion of cases arising under the act, see R. R. Formoy: *The Historical Foundations of Modern Company Law.* Sweet and Maxwell, Ltd., London, 1923.

nificant in extending European influence and in spreading European civilization. But their very success in these respects inevitably brought their decline, for as they established orderly government on land and suppressed piracy at sea, the necessity for their continued existence disappeared and the government proceeded to take over their activities. Moreover, the rise of representative government in England gradually undermined the idea of monopolistic control of foreign trade; as a result, the administration of the colonies was taken over by the government. The foreign trade was thrown open to all who wished to participate, and the great trading companies ceased to exist.

II. The Joint Stock Company in the United States

The joint stock company for business purposes had a slow development in America. During the early colonial times, several companies had been organized in England for colonizing or trading in America. In the later colonial period, several companies were organized in America for fishing, whaling, shipping, and trading with the Indians. Still later a few ventures were undertaken in the construction and operation of toll-roads and bridges and saw-milling. It is difficult to determine how many of these were joint stock companies, for although some were popularly designated as companies, it is probable that most of them were partnerships.

The joint stock company form of organization was adopted by many colonial land companies, particularly in New England. Acting on the basis of agreements between the members, the companies acquired title to land which they in turn sold to settlers. They could bring suit, make by-laws providing for their internal administration, and make assessments upon the members if necessary to pay expenses. They held annual meetings which were characterized by festivals and social features in addition to the transaction of business. Attendance upon such meetings was compulsory and fines were levied upon absentees.

The Bubble Act was in force in the American colonies from 1741 until the Revolution. The Bubble Act was extended to America by an act of Parliament in 1741, and after that date no association of more than six persons, the shares of which were transferable, could be formed without a specific grant of authority.[8] The Act

[8] S. E. Baldwin: "American Business Corporations before 1789," *Publications of American Historical Association,* 1902, Vol. I, p. 263.

was still in force at the time of the Revolution, but it was not considered a part of the American law after the Revolution. On the contrary, the courts have frequently held that agreements for organizing a business with transferable shares were valid at common law. The joint stock principle has persisted and forms a part of the present body of common law.

The joint stock company is now regulated by statute. Although joint stock companies may be formed as common-law organizations, they are regulated by legislation in many states. The law prescribes the method of formation, and the liabilities and duties of the shareholders and directors. The details of these provisions vary somewhat with the state.

The joint stock company is formed by agreement among the shareholders. The contract for the formation of a joint stock company is called the articles of association. It states the name of the company, the principal place of business, the date of organization, the purpose for which the company is formed, the total capital, the number of shares into which the capital is divided and their par value, and the method of issuance and transfer of the shares. It may provide that the death of a member will not cause the dissolution of the company or have any effect upon the operation of the business; that the estate of a deceased shareholder merely succeeds to his rights in the company. The agreement also indicates what officers the company shall have and what their powers and duties shall be. It usually states the names of the first board of governors, the method of electing the board of governors, the period of duration of the company or association, and the method of termination prior to that time. In New York State a copy of this agreement must be filed with the recorder of deeds of the county in which the company expects to do business.

Ownership of an interest in the company is evidenced by shares of stock. It was long ago determined that even a common-law organization can issue shares of stock, and that it can issue more than one kind of stock. As evidence of the ownership of shares, the purchaser or investor receives a stock certificate, stating the number of shares represented by the certificate, and the rights and privileges of the owner together with any important limitations upon his rights. These certificates may be assigned or transferred just like the shares of stock of a corporation.

The joint stock company is not usually considered a separate legal entity. In this important respect it resembles the partnership

and differs from the corporation. The fact that the joint stock company is not a separate entity or legal person means that it cannot hold the title to real estate, sue, or be sued in its own name; in suits at law and in conveyances of real property the company must act in the names of its shareholders, unless the statute makes other provisions. In New York, real estate may be held in the name of the president or other officer, and suits are instituted in the name of the president or the treasurer.[9] In some states, however, the joint stock company is treated like a partnership, and suits must be brought in the name of every stockholder.

Members of the joint stock company are liable for its debts unless the statute authorizes exemption. The joint stock company resembles a partnership in that the holders of its stock are liable to an unlimited amount for its debts. However, the statutes may, and often do, limit this liability so that in practice the shareholder is not usually subject to assessment. The exemption is secured by the statute and by the inclusion in the articles of association of a provision similar to the following:

> The board of governors shall have no power to bind the shareholders or members, personally; and in every written contract or undertaking they shall enter into relating to the business of this association, its property or any part thereof, reference shall be made to this agreement; and the person, firm, or corporation so contracting with the board of directors shall look only to the funds and property, legal and equitable, of this association for the payment of any debt, damage, judgment, or decree or of any money that may become due and payable in any way by reason of the contract or undertaking; and neither the board of governors nor the shareholders nor members present or future shall be personally liable therefor or for any debt incurred or engagement or contract made by the said board of governors.[10]

The joint stock company form of organization permits of concentrated and specialized management. The organization of the joint stock company consists of: (1) the shareholders, (2) the board of governors, and (3) the officers. The *shareholders* are like the stockholders of the corporation in that they have no power to act for the company or to make contracts in its name: their participation in the management of the company is restricted to the par-

[9] Several states treat joint stock companies as entities, and for some purposes the United States Supreme Court so considers them. United States *v.* Adams Express Company, 229 U.S. 381 (1913).

[10] From articles of the Pierce Fordyce Oil Association, a joint stock association.

ticipation in the annual meetings of the shareholders, at which governors are elected and matters which are brought before the shareholders by the board are acted upon. The *board of governors* is usually given the power to borrow money, to mortgage the property of the company, to make contracts, and to declare dividends; in most respects their powers are similar to the powers of the board of directors of a corporation. The *officers* are president, vice-president, secretary, treasurer, and title trustees. They are usually chosen by the board of governors, and their powers and duties are prescribed by the articles of association. The title trustees hold title to all property of the company, holding it in trust for the members. Title to property may, however, be held in the name of the president or some other officer.

III. Evaluation of the Joint Stock Company

The fact that the joint stock company is not widely used as a form of business organization is an indication that forms which are more attractive to businessmen have been developed. The joint stock company even at the present time is not without some advantages, and in the sixteenth and seventeenth centuries it offered a marked advance over the partnership in enterprises requiring large amounts of capital. An extended discussion of the business and social advantages of the enterprises which sell stock to the public, and the problems which the sale of the stock has created, will be deferred to later chapters, in which the corporation will be discussed. Much that will be said about the diffusion of stock ownership in a corporation would apply equally as well to the joint stock company.

The joint stock company has several advantages as a form of business organization. As compared with the general partnership, the advantages are:

1. Its life is limited only by the articles of association, and it is not terminated by the death or withdrawal of a member.

2. Its shares are easily transferable. It is not necessary to secure the permission of members when stock is sold.

3. Business administration may be separated from ownership, and a body of specialized managers may be procured to conduct the business of the company. (This has its disadvantages, just as it does in the corporation.)

As compared with the corporation, the advantages are as follows:

1. Regulation is less burdensome. Reports required by the state are fewer in number. The joint stock company is not required to pay a tax when it is organized. Amendments to its articles of association are made by vote of the members without the necessity of a state fee. The company can enter any state to do business without the payment of a fee or tax. The company is, however, treated as a corporation for purposes of income taxes, property taxes, and taxes on transfers of stock.

2. It is easy to form. The legal procedure is less complicated, since it is a common-law organization and may be formed merely by the drawing up of a contract between the members.

The joint stock company has serious disadvantages. The principal objections to the joint stock company arise from the fact that it is not a legal entity. The objections are as follows:

1. The owners of shares may be held for the debts of the company except in those states where the statute limits the liability. However, if the shareholders do not attempt to diversify their investments, the liability feature may not be a serious objection. The question of liability may never arise if the company is well managed. Moreover, a joint stock company may confine its activities to those states where it is granted limited liability.

2. A joint stock company can bring suit only in the names of the individual shareholders, all of whom must be made parties to the suit. This is a serious objection since the company cannot transact its regular business in an orderly manner.

3. A joint stock company cannot hold title to real estate in its own name but must hold it in the name of one or more officers or trustees. This is also a serious objection.

IV. Special Forms of the Joint Stock Company

Two forms of business organization which are common in some sections of the United States may be regarded as forms of the joint stock company. They are the mining partnership and the partnership association.

The mining partnership was developed in mining industries in England and America. The mining partnership is known to have been a common form of organization in mining enterprises in Eng-

The partnership association is authorized by law in a few states. Among the states providing by statute for the partnership association are Pennsylvania, Michigan, Virginia, New Jersey, and Ohio. Provision for this form of organization was first made by Pennsylvania in 1874, and since that time it has been extensively used there for companies not doing business beyond the boundaries of the state. The partnership association enjoys limited liability; that is, the members cannot be called upon to pay its debts. Ownership in the association is represented by shares of stock which may be transferred, but the purchaser of the shares must be acceptable to the other members and is admitted only after a favorable vote by them; if the prospective purchaser of the share of the retiring member is not acceptable to the other members, the latter are obliged to purchase the interest at a price that is agreeable to all; and if the members cannot agree, a court may be called upon to fix the price. The partnership association has a board of directors, and in many respects is organized like the ordinary joint stock company. Well-known companies which use this form of organization include the Youngstown Coke Co., Tidewater Pipe Co., Producers and Refiners Oil Co., and the Globe Refining Co.[13]

The partnership association is formed by filing a certificate of organization with the secretary of state and with the recorder of deeds in the county in which it is proposed to do business, and by paying a state tax. This certificate contains much the same information as that contained in the articles of association. To secure the privilege of limited liability for the members, the laws of the state prescribing the method of organization must be strictly complied with.

The partnership association is not widely used by concerns which do business in more than one state, for the reason that its legal position is somewhat uncertain. Most states refuse to recognize it as a distinct form of organization, and treat it as an ordinary partnership with unlimited liability.

Questions

1. What is the difference between the joint stock company and the partnership?

2. What is the difference between the joint stock company and the corporation?

[13] W. G. McLoughlin: "Law of Business Organization," *John Marshall Law Journal*, Sept., 1935, Vol. 5, pp. 215-225.

3. How were the first joint stock companies developed in Italy?

4. How does the joint stock company resemble the craft guild?

5. What is meant by a regulated company?

6. Trace the steps in the development of the joint stock company from the regulated company.

7. Why was the joint stock company better suited to the development of foreign trade than the regulated company?

8. Did all of the early joint stock companies receive charters? Was a charter necessary? Why?

9. Compare the evils practiced during the stock market boom prior to 1720 with abuses during recent similar periods.

10. What were the provisions of the Bubble Act? Did it prohibit the formation of companies with transferable shares at common law, that is, without a charter from the government?

11. Is a charter necessary at the present time for the formation of a company with transferable shares?

12. What were the usual business ventures in America during the Colonial period? How were they organized?

13. What should be included in the articles of association?

14. What is meant by the statement that the joint stock company is not a legal entity? What difference does it make?

15. Compare the joint stock company with the general partnership in the following respects:

a) Name of contract for formation.
b) By whom managed.
c) Right of members to share in management.
d) Right of members to make contracts for the business.
e) Liability of members.
f) How members are designated.
g) What shares of ownership are represented by.
h) Effect of transfer of shares upon life of the firm or company.
i) Title to property held by whom.
j) Is or is not a legal entity.
k) Most serious weakness.
l) Greatest advantage.

16. Compare the mining partnership with the general partnership in the following respects:

a) Admission of members.
b) Liability of members.
c) Right of members to participate in management.

17. Compare the partnership association with the general partnership and also the mining partnership with respect to the features mentioned in Question 16.

18. In what types of enterprise other than mining is the mining partnership used as a form of organization?

19. Five persons own a retail store which is organized as a partnership. They are considering the possibility of changing the form of organization to joint stock company or partnership association. Place of business is a medium-sized city in Pennsylvania. The owners supply a total of $30,000 of the capital and have borrowed $10,000. They need to borrow an additional $10,000 during the next three years. What would be your advice to them?

CHAPTER V

The Business Trust

The business trust is a form of organization which developed in Massachusetts, though it has been adopted by businesses in many other states. It is formed by an agreement which provides that property constituting a trust fund is turned over to a group of trustees to be managed by them for the benefit of the beneficiaries who are the owners of the fund. The beneficiaries hold transferable shares which entitle them to share ratably in the income from the property and, at the termination of the trust, in the proceeds.[1] Thus, there are three parties to the trust: first, the creators or settlers who establish the trust by transferring money, securities, or property to the trustees for the benefit of another person or persons; second, the trustees who take title to the assets and manage them for the benefit of the persons named in the agreement; and third, the beneficiaries or shareholders who are entitled to share in the dividends, when declared, and in the assets at dissolution.

The business trust was first organized in Massachusetts because a corporation could not be organized under the laws of that state to deal in land. The state feared that if a corporation had a duration of many years and continued decade after decade to acquire land, it might eventually become stronger than the state itself. Business trusts are known to have existed since about 1820, though they were few in number until recently. They are also called Massachusetts trusts, common-law trusts, common-law companies, associations under deeds of trust, and trust estates.

I. Formation of the Trust

The business trust was orginally formed under the common law and not under statute law, and at the present time it may be organized under the laws of many states without any express provision for it by legislation. A few states have provided for their

[1] Hecht *v.* Malley, 265 U.S. 144, 146 (1924).

formation and their regulation by statute, the law specifying that the trust may sue and be sued in its trust name and that the liability of trustees and beneficiaries shall be limited. Among the states regulating the business trust by statute are Massachusetts, Oklahoma, and Wisconsin. Several states refuse to recognize it as a form of business organization, holding that limited liability of the shareholders can be achieved only by compliance with the statutes authorizing the organization of corporations. Among the states that refuse to recognize it are Texas, Kansas, Washington, Florida, and Indiana. The position of the trust in many other states is uncertain.

The business trust was a development of the common-law trust. Its nature may perhaps be best understood by a study of the simpler forms of trusts from which it has developed. A trust may be created by the owner of property by his vesting title to it in a trustee for designated purposes. Thus, a person who is making a will may create a trust with the stipulation that the income from certain property is to be paid to a designated beneficiary during the lifetime of the beneficiary or for a certain number of years. At the end of that time the principal of the trust may be paid to a designated person or institution. If the beneficiary receives the income for the remainder of his life, he is called a life tenant, and the person who receives the corpus of the trust at his death is called a remainderman. Similar trusts, called life insurance trusts, may be established by having the proceeds of a life insurance policy paid to a trustee to manage for the benefit of certain designated beneficiaries.

Individuals who wish to borrow money frequently create trusts in order to provide security for a loan. Property is transferred to a trustee to be held as security. When the loan has been repaid, the property is returned to the owner.

Living trusts may provide that the creator of the trust is to receive the income from the property during his lifetime and that at his death the property is to go to a designated person or institution.

Another form of trust is the community trust, which was first created at Cleveland in 1914. It is formed to provide for the management of funds or property, the income from which is devoted to philanthropic purposes. A trustee, usually a trust company, is named to invest the funds composing the trust and to hold title to the property as trustee. A committee, most of whose members are appointed by public authorities, decides how the income is to be

spent; the committee may use the funds where they will do the greatest good, and it may shift the funds from one purpose to another from year to year. The characteristics of the community trust are: (1) It is established for the benefit of the public generally or some portion of it. (2) The beneficiaries are indefinite. (3) Its duration is not limited by the law against perpetuities.

If charitable trusts are devoted to specific purposes by the terms of the trust agreement, they may become obsolete after a term of years because the need for the trust disappears. For example, a charitable foundation to maintain a hospital for lepers was once established in England, but in time leprosy ceased to exist in England. In another instance, a foundation was established for the benefit of apprentices in a certain trade; and when machine production was introduced in the industry, there were no apprentices to receive the income from the trust. In such cases, the courts may direct that the proceeds be used for a purpose as nearly like the original object of the foundation as possible, but the difficulty may be avoided by the use of the community trust.[2]

A form of trust more closely resembling the business trust is one which provides that business property is to be managed by a trustee, the income to go to certain designated persons, perhaps including the creator of the trust himself. For example, *A* might transfer the title to a grocery store to his father, *B*, to be managed by *B*, and the income to be paid in equal amounts to *A* and *B* and *A's* brothers, *C* and *D*. *A* would thus be the creator of the estate and also one of the beneficiaries. *B* would act as trustee and would also be a beneficiary.

Trusts are of two general classes: the dry or passive, and the active. The dry or passive trust is one in which the trustee does not manage the property but merely takes title to it; an example is the trust which is created by the transfer of the title to property to a trustee as security for a loan. The active trust is one in which the trustee not only holds the title to the property but also has the authority to manage it. The business trust is itself an active trust. However, none of the trusts just described are business trusts since they do not issue transferable shares.

The business trust is created by the turning over of the property of a business to designated trustees. A business trust is established by creators or investors, who turn over cash or other property

[2] Charles M. Howard: "Charitable Trusts in Maryland," *Maryland Law Review*, Feb., 1937, Vol. 1, pp. 105-127.

to the trustees named in the trust agreement. The trustees are given the authority to use the cash to purchase real estate, factory equipment, or other productive and trading assets, and to manage the business according to their own judgment. The beneficial interest in all of the property constituting the trust is in the creators of the trust, who are also the beneficiaries; while the legal title is vested in the trustees.

The business trust may engage in varied business activities just as any other business might do. The trustees render an accounting to the beneficiaries from time to time, and they distribute profits to the beneficiaries whenever they deem it expedient to do so.

The terms of the agreement are recited in the deed of trust. The business trust, like other trusts, is created by the drawing up of a deed of trust which is a contract or agreement between the creators and the trustees. The creators have the right to specify the manner in which the trust estate shall be invested and how the business shall be conducted. The deed of trust must in some states be filed with a state official. It usually covers the following points:

1. The name of the trust and provision for the adoption of a seal.

2. The nature of the business to be conducted.

3. The property which is to constitute the *corpus* of the trust.

4. The names of the original trustees, their powers, duties, liabilities, and remuneration.

5. The procedure to be followed in filling vacancies among the trustees.

6. The rights and duties of the beneficiaries.

7. Provision for the distribution of profits.

8. The rights of creditors. The usual provision is that creditors can look only to the funds and property of the trust in settlement of their claims, not to the property of the shareholders outside the trust estate.

9. Provision for subsequent contributions to the trust estate by later settlers. In other words, provision may be made for the issue of additional trust certificates for other property. Trust certificates may also be issued to the certificate holders as a certificate dividend.

10. The duration of the trust. The duration is limited by state

law. Usually the trust may not last more than 21 years after the death of some designated person or persons.

II. Powers and Duties of Trustees

The trustees are in much the same position as the directors of a corporation so far as their powers and duties are concerned, though their legal position is very different. Their powers and duties are set forth in the trust agreement, those of the directors of a corporation in the charter and the statutes providing for incorporation. Both the trustees and the directors exercise general supervision over the affairs of the business, and both groups have certain very definite obligations and responsibilities.

The trustees have broad powers in managing the trust. After they are appointed, they act in their own right as principals, not as agents of the beneficiaries. The trustees may determine the method to be followed in carrying out the provisions of the trust, and so long as they perform their duties honestly, they are not directly responsible to anyone. The control exercised over the trustees by the beneficiaries is limited to compelling them to render an account of the trust and charging them in court with dishonesty or neglect of duty.

The deed of trust usually requires the trustees to supervise the conduct of the affairs of the business, but it permits them to delegate the actual management to other persons. The trust may have a president, a treasurer, a secretary, and one or more vice-presidents as the deed of trust provides.

The trustees are frequently elected for the life of the trust, while officers are chosen by the trustees, usually from their own number, for a term of one year. The trustees are sometimes elected for a term of years, and they may be divided into two or more classes, with the term of one class expiring each year. The declaration of trust usually provides that the remaining trustees may fill vacancies as they occur through expiration of the term of office, death, resignation, or removal of a trustee. If the declaration of trust makes no provision for filling vacancies, they may be filled by the judge of a court.

The trustees may not ordinarily be removed from office by the beneficiaries. If sufficient cause for removal is shown, however, such as misconduct, mismanagement, or a lack of harmony between the trustees which would endanger the success of the trust, a bene-

ficiary may secure the removal of a trustee by appeal to the courts. The trust deed usually provides for the contingency of the removal of a trustee.

The trustees represent the trust in suits at law. Suits for or against the trust are brought in the name of the trustees. Almost insuperable difficulties would be encountered if suits had to be brought by or against the beneficiaries. But if ownership in the trust is not represented by transferable shares, some states require that the beneficiaries be named in the suit. It is obvious that the beneficiaries may have a real stake in the outcome of such suits, and there is good reason for joining them with the trustees in the suit if it is possible to do so.

The exemption of the trustees from liability for debts of the trust can be secured only by contract. Unless the trustees are made exempt from liability for the debts of the trust by special provision, they may be liable to creditors. Since the trustees are not agents of the beneficiaries but principals in their own right, and since the beneficiaries are not liable for the acts of the trustees, it follows that the trustees themselves are liable. They are liable not only on contracts which they make but also for damages for whatever injuries they may inflict upon the persons or property of others. They may, however, secure exemption from liability for the debts of the trust by contract with creditors. To assure themselves of this exemption, they must insert in every contract, including contracts for the purchase of merchandise and for the borrowing of money, a provision that the trustees shall not be personally liable and that the creditor will look solely to the trust property for the satisfaction of the obligation. If this is done, the trustees are not liable unless they have been guilty of misrepresenting or fraudulently concealing the true condition of the trust estate. The trustees may further protect themselves by the insertion of a clause in the deed of trust to the effect that if they become personally liable to third persons by some act which does not represent bad faith, they may be indemnified from the property of the trust.

The trustees are not liable to the beneficiaries unless they are guilty of gross negligence or fraud. They are not liable for losses sustained by the trust fund due to circumstances not under their control or for losses due to ordinary negligence. If the beneficiary were managing his own estate, he might suffer losses caused by his own negligence. The trustees are, therefore, liable only for losses due to their gross negligence or to their failure to exercise the care

which an ordinarily prudent man would exercise over his own property: this is the rule at common law, but often provision to this effect is stated in the trust deed itself. The trustees are liable to the beneficiaries if they use the property of the trust in any manner other than that specified by the trust deed.

Trustees are entitled to compensation for their services. The compensation of trustees for managing the estate is usually named in the trust agreement, but if the compensation is not named, they still are entitled to reasonable compensation. If it is necessary, the trustees may apply to a court of law, which will determine what is a reasonable amount. The court, in such cases, is justified in fixing a compensation high enough to make possible the procuring of qualified trustees. This is different from the rule affecting the pay of directors of corporations, who in most states are not entitled to compensation unless it is specifically provided in the corporate charter.

Trustees may be given the power to terminate the trust. The right of the trustees to dissolve the trust or to sell its assets may be given in the trust indenture. If given such power, the trustees usually are not required to obtain the consent of beneficiaries or shareholders. The trustees may in such cases transfer the entire assets to another trust or a corporation in exchange for cash or the bonds or stock of the other company. Thus, the certificate holders do not have the right usually accorded the stockholders in a corporation to decide the question of termination of the enterprise or its merger with another business. The certificate holders in the trust also lack the right to have their shares appraised to determine whether they are receiving their true value at the dissolution of the trust, a right usually accorded the stockholders in a corporation. However, the trust agreement may provide that termination can be effected only after a certain percentage, usually two-thirds or three-fourths, of the holders of the outstanding shares have given their assent.

III. Beneficiaries of the Trust

The beneficiaries have somewhat the same relation to the trust as stockholders have to the corporation. There are important legal differences, however, which must be recognized.

The beneficiary of the trust has certain rights. The most important rights of the beneficiary are the right to a pro rata share in the income of the trust and, in case of the dissolution of the trust,

to a share in the residue of the assets after prior claims have been paid. Since the beneficiaries are given only the residue, they are not assured the return of their original capital or trust fund. The accrued earnings of the trust may be used to pay dividends on the trust certificates, but the trust agreement usually gives the trustees wide discretionary power in the declaration of dividends. The decision of the trustees concerning the amount of the accumulated earnings to use for the payment of dividends is usually considered final. In this respect the powers of the trustees are similar to the powers of the directors of the corporation.

The beneficiary is usually given the right to statements concerning the financial condition of the trust. Such statements are usually submitted annually. They set forth the condition of the trust at the end of the year and the earnings for the year.

The beneficiaries do not have the right to remove the trustees or to elect others in their places. In several states it has been held that if they reserve the right to remove the trustees without cause and to elect others to take their places, the organization is an ordinary partnership and the holders of the trust certificates are liable as partners.[3] The organization would probably be considered a partnership also if the holders of the trust certificates reserved the right to elect the trustees annually or otherwise seemed to be exercising a continuing control over the management of the business.[4] For example, in a case in Massachusetts in 1914,[5] the trust agreement provided that the holders of two-thirds of the outstanding shares could remove any or all of the trustees at any time and appoint others to take their places; they could terminate the trust at any time and require the conveyance of the trust property to a corporation; they could amend the declaration of trust or the by-laws. The reservation of such great powers as these to the shareholders, it was decided, indicated that the agreement was a partnership agreement, not a declaration or deed of trust.

[3] See Priestly *v.* Burrill, 230 Mass. 452, 120 N.E. 100 (1918); also Williams *v.* Boston, 208 Mass. 497, 94 N.E. 808 (1911).

[4] The relation of the beneficiary to the trust has been summarized by the United States Supreme Court in the following statement: "Under the Massachusetts decisions these trust instruments are held to create either pure trusts or partnerships, according to the way in which the trustees conduct the affairs committed to their charge. If they are free from the control of the certificate holders in the management of the property, a trust is created; but if the certificate holders are associated together in the control of the property as principals and the trustees are merely managing agents, a partnership relation between the certificate holders is created." Hecht *v.* Malley, 265 U.S. 144, 147 (1924).

[5] Frost *v.* Thompson, 219 Mass. 360, 106 N.E. 1009 (1914).

The beneficiaries of the trust may be grouped into classes. While the holders of the trust certificates have the right to share in dividends declared by the trustees, they do not necessarily share equally. As in the corporation, provision may be made for preferred and common certificates, and even for classes of both. Some certificate holders may receive a stipulated dividend income before any payment is made to others. In other words, certain shares or certificates may be preferred as to income.

Similarly, at the dissolution of the trust some certificate holders may be paid a stipulated amount, usually the par value of the certificate, before anything is paid on the other shares. These certificates are said to be preferred as to assets. Shares preferred as to assets may also be classed as first preferred shares and second preferred shares. The possibilities of classifying shares in the trust are, in fact, almost as great as in the corporation.

Trust shares may be transferred. Although the business trust is formed under common law, its shares may be transferred without terminating the trust. The early development of the joint stock company established the fact that by agreement among the organizers it was possible to form a company with transferable shares without the sanction of either a special charter or a general incorporating law. Differences of opinion concerning the meaning of the Bubble Act of 1720 for a time caused this point to be in some doubt, but it was finally established that the common law permitted an agreement for the issuance of transferable shares.

IV. Evaluation of the Trust

The business trust has been used as a method of organization by a great many large enterprises. Among the industrial businesses which have employed this form are the North American Pulp and Paper Company, the Mackay Companies, the Great Northern Ore Properties, and the Associated Hardware Companies. A number of investment companies, particularly those sponsored by banking houses in Boston, have been organized as business trusts. In the public-utility field the Chicago Elevated Railways is one of the well-known companies employing this form of organization.

The business trust has been used to acquire the stocks of public-utility corporations in states which prohibit a foreign corporation from acquiring the control of domestic public utilities. For example, the Central Public Service Corporation organized a

business trust, the Seaboard Investment Trust, to acquire a controlling interest in the stock of the Washington Gas Light Company, which it could not acquire directly. The same device was used by the Associated Gas and Electric Company, which organized the New England Gas and Electric Association to purchase and to hold the stocks of a gas and electric company in Massachusetts. Other trusts formed to acquire the securities of public-utility corporations are the New England Power Association, the New England Power Securities Company, the Massachusetts Utilities Association, and the International Hydro-Electric System.

The business trust has certain advantages. Among the advantages which may be urged for the business trust are the following:

1. The trust possesses great flexibility in its activities. The deed of trust contains the only restrictions upon the nature of the business to be carried on, except for general statutes which apply to all businesses, and the deed of trust is drawn up by the persons interested in the business. They may therefore make its terms as broad as they please.

2. The trust possesses great flexibility in organization. The organizers are not restricted as to the amount and classification of the stocks and bonds which may be issued. The deed of trust may provide for any number of trustees, and the trustees are not required to meet any residential requirements. Moreover, the trustees may hold their meetings in any state.

3. There is a minimum of formality in the creation of the trust. Except where the common law has been supplemented by statute, there are no reports to be filed with state officers. The only legal formality is the drawing up of the trust agreement.

4. When the trust enters other states to do business, there is less formality than is required of the corporation. The trustees, as citizens, have the right to enter any state, and they have the full protection of the law. They cannot be burdened with taxes or reports not required of resident trustees. This is an advantage over the corporation which must have the permission of a state and may be required to pay taxes to enter.

5. The management is permanent. The trust has the advantage of permanent existence regardless of changes in the ownership of its shares. This is an advantage over the partnership.

6. Limited liability of certificate holders and trustees may be secured by contract.

7. The taxes required of the business trust are lower than corporate taxes. The trust is not required to pay a franchise tax when it is organized, though it does pay a fee for filing a copy of the trust agreement with the recorder of deeds or the secretary of state. The trust may enter any state to do business without the payment of fees or the observance of any of the formalities required of a corporation. For purposes of the income tax, property taxes, and taxes on the transfer of shares, the trust has no advantage over the corporation.

The advantages of the business trust as a form of business organization arise principally from the fact that the states have not undertaken a detailed regulation of it. They have not restricted it or taxed it heavily, largely because it is a comparatively new form of organization and also because it has not been widely adopted by businesses as a method of organization. It may in time be regulated and taxed as much as the corporation, and the advantages which it enjoys at present may prove to be only temporary.

The principal disadvantage of the trust lies in the uncertainty surrounding it. Since the trust is a relatively new form of business organization, a complete body of law pertaining to it has not yet been developed. Decades of litigation and court precedent are required before legal decisions can be obtained and precedents established on all points pertaining to a form of business organization. Aside, therefore, from the uncertainty which naturally follows from the fact that each state is a separate legal jurisdiction and that the law is constantly in a state of change, the law of business trusts suffers from its comparative newness. The principal points concerning which there is uncertainty are as follows:

1. To what extent may the beneficiaries also be trustees? The trustees need not be chosen from the shareholders, but the holding of trust certificates does not disqualify one from acting also as a trustee. However, if the trust is composed of only a few persons all of whom act as trustees, the element of trust disappears, and the business becomes a partnership.[6] In legal terms, if the equitable owners, or beneficiaries, and the legal owners, or trustees, become one and the same group of persons, the equitable estate is merged with the legal estate and the trust ceases to exist. Obviously one person cannot be a trustee if he himself is the sole creator of the estate and the sole beneficiary.[7] To what extent the beneficiaries

[6] Neville *v.* Gifford, 136 N.E. 160 (Mass., 1920).

[7] Cunningham *v.* Bright, 117 N.E. 909 (Mass., 1917).

and the trustees may be the same group, however, is still undetermined.

2. To what extent may the certificate holders retain control over the appointment and removal of the trustees and the dissolution of the trust? This question is further confused by the view of the courts in some states that, even if the business is conducted as a pure trust, the shareholders are liable as partners.[8] Moreover, the fact that the business trust has been approved as a form of business organization in a certain state does not give any assurance that it will continue to be accepted, since a number of courts which formerly recognized it have reversed their opinions.

3. What are the rights of the shareholder in relation to financial management? In a corporation the stockholder has the right to inspect the record of stockholders; but whether the holder of trust certificates has a similar right is a disputed point. Another moot point is whether the shareholder in a business trust can legally object to an unreasonable accumulation of surplus profits and the refusal of the trustees to declare a dividend.

As long as the law of business trusts continues to be uncertain, and the court decisions in the various states differ on important questions, the trust will continue to hold a minor place as a type of business enterprise. Moreover, there is no doubt that if it should come to play a predominating role, the legislatures of the various states would pass regulatory laws which would remove many of the advantages which it now enjoys.

Questions

1. What are the three parties to the trust?
2. What other name is given to the beneficiaries?
3. What are the rights of the three parties to the trust?
4. Why was the state of Massachusetts afraid of the corporation? What events in history had caused the fear?
5. By what other names is the business trust known?
6. What is a life insurance trust? A living trust? A community trust? A charitable trust? How does the business trust differ from each of these trusts?
7. Distinguish between the dry trust and the active trust. Indicate uses for each type.
8. Is the business trust a dry trust or an active trust?

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[8] Thompson *v.* Schmitt, 115 Texas 53, 274 S.W. 544 (1925).

9. What is the procedure followed in the creation of a business trust?

10. What is included in the trust agreement?

11. What is the reason for the limit of 21 years after the death of a designated person or persons as the life of the trust? Do you see any relation between the life of a trust and time required for a child to reach maturity in the eyes of the law?

12. How do the powers of the trustees compare with the powers of partners in the management of a business?

13. How are vacancies in the board of trustees filled?

14. What is the liability of the trustees in case of mismanagement?

15. Compare the position of beneficiaries of the business trust with that of shareholders in the joint stock company.

16. What is the reason for having more than one class of beneficiaries?

17. What are the uncertainties surrounding the legal position of the business trust?

18. Five persons own a business which is organized as a partnership. They contemplate changing to a business trust with themselves as trustees. Is this possible? What would they be required to do in order to change to a business trust?

19. A business trust which conducts business in several states is unable to pay its debts. Some of the states recognize the business trust as a separate form of business organization and some consider it a partnership. How would the affairs be settled?

20. Compare the business trust and the joint stock company in the following respects:

a) Name of contract to form.
b) Formed by common law or statutory law.
c) Recognized as a legal entity.
d) Liability of shareholders.
e) Shares transferable.
f) Persons or officers holding title to property.
g) Names of managers.

PART TWO

The Corporation

CHAPTER VI

History of the Corporation

The corporation is usually defined as a legal person with continuous existence regardless of changes in the group of persons comprising its shareholders, officers, or directors. It developed because an agency was needed to hold and transmit rights or franchises which would in time be lost if they were granted to natural persons. Another and quite distinct function of an institution with continuous existence is the assumption of obligations and particularly debts or liabilities which continue to bind the organization regardless of changes in the membership. If the corporation is considered from the point of view of liabilities rather than rights of ownership, its beginning was at least as early as the Greek city states. Such a broad concept of the corporation would even indicate that earlier states of ancient times were corporations.

I. Corporations in Rome

The Romans were not the first to use the corporation, but they were the first to use it for private or business purposes. They did not call it a corporation, since the name is modern in origin, but they called it *collegium* or college.

The Romans used the corporation in organizing municipal and religious activities. The earliest use of the corporation was in municipal affairs. As population began to be concentrated in cities, the municipalities gradually assumed duties and entered upon activities which required the ownership of property; but ownership of property implied continuous existence, and thus the idea of the corporation as a continuing organization, regardless of changes in its membership, gradually evolved. This idea was in time applied

to other organizations. Various military societies took on the corporate form; colleges of priests were created; and as the Christian church grew stronger, various other church societies were organized as corporations. These early associations or corporations did not have state charters, being considered as having continuous existence merely as a result of the agreement of association.

The Romans used the business corporation to develop trading enterprises. Rome began as an agricultural community, and throughout its early history it continued to be self-sufficing, with little interest in trade and commerce. When the Romans had conquered the lands along the Mediterranean Sea and established supremacy over Greece, the possibilities of commerce and also of manufacturing were greatly increased. During the days of the Roman Empire, there was much trade in grain and other foodstuffs, copperware and other metals, textiles, art goods, and other types of merchandise. Corporations were formed to carry on trade throughout the Mediterranean area, to prospect for and mine gold, to construct public works, to mine salt, to collect taxes, and to engage in other business activities. How many such corporations there were, it is impossible to say, though numerous enterprises were no doubt conducted by single proprietorships and partnerships as well as corporations.

Roman corporations had many of the attributes of a legal person. Roman corporations could hold real as well as personal property. They had capital stock though they did not issue stock certificates. Instead of issuing certificates, they registered the owners of shares on their books. Corporations were free to adopt regulations governing their internal affairs. Whether Roman corporations achieved limited liability is a moot point, though it is known that in some cases the shareholders were assessed to pay creditors. In any case it is doubtful that the Romans thought of the corporation as a separate legal person for this idea appears to be a distinctly modern development.

II. The Beginnings of the Modern Corporation

The corporation suffered a marked decline with the fall of Rome. The German invaders were not city dwellers or traders; instead, they lived in town and country and cultivated the land. Consequently the corporate device was little used by them, though the

idea of the corporation persisted and some private corporations continued to exist.

The corporation of the Middle Ages was essentially a device for organizing non-commercial enterprises. It was used principally by church organizations and by cities and towns. Various church orders, including abbeys, monasteries, and bishoprics, were incorporated by the Pope; and later, schools and municipalities received corporate powers and responsibilities from the king. Corporations for commercial or business enterprises were not viewed with favor by the church or the government, since incorporation conferred special privileges and to some extent deprived the ordinary courts of jurisdiction over the members. It is significant that the corporations of the Middle Ages were formed not because it was the desire of the members to assume the corporate form, but because it was to the advantage of church or state to impose the corporate form with its responsibilities and duties. In many cases it was easier to deal with the representatives of an organized body than with a number of individuals.

Both church and state assumed the power of creating corporations. Thus, in 1210 the Pope conferred on the University of Paris, which had begun as a cathedral school, the power to elect a proctor to represent the members and to answer for them as a body in suits against them before the court at Rome. The fact that the church assumed the authority to grant corporate powers lends support to the belief that the earliest types of corporations both on the Continent and in England can be traced to Roman law, with the church as the connecting link across the Dark Ages.

The power to grant corporate privileges and responsibilities was assumed also by the king very early in the history of modern European nations. The early kings conferred corporate powers principally upon the towns and other nonreligious organizations. The assumption, by both the king and the Pope, of the power to grant corporate rights and to impose corporate responsibility represented one phase of the early conflict of authority between the church and the state.

The church made another contribution to the development of the corporation through its ownership of land. As early as the eleventh century, the church owned land in England but there was much confusion concerning the question of who held title to it. At first the church building and the land on which it stood were thought of as belonging to the person who owned the land adjacent to it.

Later, persons provided in their wills that land should be given to a departed saint; and although such wills were considered legal, it was ultimately recognized that the saint could not appear in court or otherwise protect his interests. In time the church itself or its bishop or other representative was considered as the holder of the title to the property. The church or an office in it continued a legal life from one generation to another regardless of changes in the natural persons who represented it or held office. Thus, the idea of continuing existence was gradually evolved.

The corporation in England was influenced less by Roman than by Germanic institutions. The Roman occupation did not leave the corporation in England as a permanent institution. It is doubtful whether any Roman corporations survived the fall of Roman power in the British Isles. It has been contended that Oxford and Cambridge may have been founded as a result of Roman influence, and it is known that they were not created by any act of the English Crown; it seems unlikely, however, that their origin can be traced to Rome. The idea of the corporation probably made its way into English law through the recognition of fortified communities as cities or towns. The borough was originally a town having a citadel or means of defense; it was essentially an instrument of protection and government. In fact, English towns had been recognized as having functions of exceptional importance before the Norman Conquest, and their position was made more secure by William I. He granted a charter to the City of London, which implied a sanctioning of the rights and privileges which its citizens enjoyed. Other municipalities also received charters from the king which gave them corporate powers, freedom of trade, greater freedom in acquiring and disposing of title to land, power to establish and conduct town courts, exemption from certain taxes, and other privileges of a similar nature.

At first the grants did not expressly state that the borough was to be a corporation; they merely conferred certain privileges. In time, however, the question of who owned the franchise naturally arose. The original townsmen died, but the privileges were passed on to others. Thus, the idea of continuous succession in time came to be associated with the corporation. Later a seal was adopted to designate the group of persons upon whom the privileges had been conferred.[1]

[1] See Robert L. Raymond: "The Genesis of the Corporation," *Harvard Law Review,* March, 1906, Vol. 19, pp. 350-365.

The municipal corporation has greatly influenced the business corporation. Many legal principles which had been developed when political corporations were the prevailing type of corporation were later applied to the business corporation. The most important of these principles was that of the continuing existence of the corporation with its rights and duties, regardless of changes in the membership; but many detailed principles of organization of the political corporation were also applied to the business corporation. This is best shown by the rules prohibiting plural voting and proxy voting. In municipal affairs, each person was allowed only one vote regardless of the amount of property he owned, and the same rule was adopted for business corporations. Persons owning large blocks of stock considered this principle unfair. They attempted to cast more than one vote at corporate elections by transferring part of their stock to their friends and instructing them how to vote. This practice, which was called "splitting stock," was condemned by an act of Parliament in 1766.[2] As late as 1832 a New Jersey court held that the directors of a bridge corporation had violated the charter by permitting stockholders to cast one vote for each share of stock owned.[3] Plural voting, the court said, would encourage speculation and monopoly, depreciate the value of the shares, and throw the government of the corporation into the hands of a few.

As for voting by proxy, the rule in political affairs was that decisions should be reached after public discussion, and if a member was not present to hear the discussion, he was not qualified to vote. It was likewise assumed that corporate affairs would be discussed at the meetings of the stockholders and that stockholders were not qualified to vote unless they were present at the meetings.

The idea of the business corporation was fully developed during the sixteenth and seventeenth centuries. Some traces of the fiction of the corporate entity may be found in English law before the beginning of the sixteenth century, but the fiction did not take definite form until the sixteenth and seventeenth centuries. During these two centuries many grants of charters were made by the English Crown for purposes of trading or colonization; in the later grants, indeed, some of the companies were expressly incorporated. In many cases the charters stated that the business was to have the

[2] Samuel Williston: "History of the Law of Business Corporations before 1880," *Harvard Law Review*, Nov., 1888, Vol. II, pp. 149, 157. The practice of splitting stock should not be confused with modern stock split-ups.

[3] Taylor *v.* Griswold, 14 N.J.L. 222 (1832).

legal powers and characteristics which are now commonly associated with the corporation, such as the right to continued existence regardless of changes in the membership of the company, the right to take legal proceedings against third persons and possibly against its own members, the right to the possession of a corporate seal, the transferability of shares without the necessity for other shareholders to be consulted, and the limited liability of members.

The doctrine of the limited liability of the stockholders was established during the latter part of the seventeenth century. The right of the creditors of the early companies to assess the stockholders in settlement of their claims arose from the fact that the company itself had the right to make additional assessments upon the stockholders. Thus, when the company expressly renounced its right to make such assessments, the creditors had no right to make them. By the end of the seventeenth century the doctrine of limited liability had developed until the individual stockholders could be held for the debts of the corporation only by express legislative enactment.[4]

The idea of limited liability was strengthened by the kings, particularly the Stuarts, in their struggle with Parliament. Acting upon the advice of their legal counsel, they advocated the theory that the corporation was a mystical person created by royal decree. The purpose of the king was to strengthen his own position by the assumption of this and other powers for the Crown. The doctrine did not result in the continued absolute power of the king, but it did help to establish the legal theory of the separate entity of the corporation, and with it the doctrine of limited liability. This doctrine was fully established by the time the Stuart rule ended in 1688.

III. Early American Corporations

The early American corporations were principally educational institutions, religious orders, and municipalities. The colonists were too busy at first with clearing the land, building homes, and fighting Indians to be concerned with organizing business corporations. Their few trading enterprises were for the most part conducted as single proprietorships or partnerships. In time, a few business ventures were incorporated.

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[4] W. S. Holdsworth: *A History of English Law,* Vol. VIII, p. 207. Little, Brown and Co., Boston, 1926.

In the American colonies, the question of who had the power to incorporate was the subject of much legal controversy. In England charters had at first been granted by the Crown; but as Parliament was able to wrest power from the king, it gradually assumed this authority for itself. At the time the American colonies were being founded, both Parliament and the Crown claimed this power. In the colonies there was the question not only of whether charters should come from the executive or the legislative branch of the government, but also of whether they should come from the colonial or the home government. Thus, four sources of charters were possible: the king, the Parliament, the colonial governor, and the colonial legislature. It seems, however, that Parliament made little attempt to assert its power in granting colonial charters; most of the charters were derived from the three other sources.

The colonial legislatures contended that the power to grant the privileges of incorporation was derived from the colonial charters, which granted powers of legislation, but the English king denied that the charter conferred such power. The incorporation of Harvard College by the Massachusetts legislature, the king's legal advisers said, was a violation of the charter, and this act was given as one reason for depriving the colony of its charter in 1684. The colonial governor claimed to have derived the power of incorporation from his right to represent the king in the administration of colonial affairs.

American colleges, municipalities, and trading companies procured their charters from all of the sources named. Thus, the city of Annapolis, Maryland, received its charter from Queen Anne. Princeton University, the University of Pennsylvania, and Rutgers College received their charters from the governor, while Harvard, Yale, and Brown were incorporated by the colonial legislatures. Some other colleges, including William and Mary, Columbia, and Dartmouth, procured their charters direct from the Crown.[5] On the other hand, the Hudson Bay Company, an American trading company, originally received its charter from the king and later secured a confirmation of the charter from Parliament.

The dispute between the colonies and the home government was not settled until the colonies declared their independence. And even after the adoption of the Constitution there remained the question of the power of the national government to incorporate as against

[5] S. E. Baldwin: *Modern Political Institutions,* p. 184.

that of the various state governments. The power of Congress to grant corporate charters was finally established in the famous case of McCulloch *v.* Maryland,[6] which involved the right of Congress to incorporate the Second Bank of the United States. Although Congress is not expressly empowered by the Constitution to grant corporate franchises, it does have the power to make all laws which are necessary and proper for carrying into execution the powers that are expressly granted. This gives Congress the power to incorporate several types of corporations, including national banks and railways.[7]

There were few business corporations in America during colonial days. The colonists were slow to grant the privilege of incorporation to business enterprises, largely because there was small need for business corporations. There seem to have been only six business corporations in colonial America.[8] These were:

1. The New York Company for Settling a Fishery in these Parts, 1675.
2. The Free Society of Traders in Pennsylvania, 1682.
3. The New London Society United for Trade and Commerce in Connecticut, 1732.
4. The Union Wharf Company in New Haven, 1760.
5. The Philadelphia Contributionship for the Insuring of Houses from Loss by Fire, 1768.
6. The Proprietors of Boston Pier, or the Long Wharf, in the Town of Boston in New England, 1772.

The names of these six companies indicate the nature of the business activities of the colonial days. One was a fishing company, two were trading companies, another was an insurance company, and two were wharf companies. None of them engaged in manufacture, which was still a domestic industry. The companies were small and they were largely local in their activities.

Few corporations were organized until after 1789. After independence was declared, the states continued to exercise the power to confer the privileges and responsibilities of incorporation upon business enterprises. During the period of the Revolutionary War,

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[6] McCulloch *v.* Maryland, 4 Wheaton 415 (1819).

[7] California *v.* Pacific Railroad Co., 127 U.S. 1 (1888).

[8] S. E. Baldwin: "American Business Corporations before 1789," *Publications of American Historical Association,* 1902, Vol. I, p. 257.

however, not many corporations were organized, for the uncertainty of the outcome of the war made business ventures extremely risky. After the war was over, the lack of power of the Confederate government and the friction between the various state governments continued to check business expansion. It was not until after the Federal Constitution was adopted and a stable government was established, in 1789, that corporations began to be formed in great numbers. Even then the number of corporations was not large as compared with the number of corporations formed in recent years.

Prior to 1800 the total number of charters granted in America to business corporations was about 335, and 90 per cent of the charters were granted after 1789. Most of the corporations formed down to 1800, however, were not engaged in industrial activities but in enterprises of a semi-public nature, such as banks, transportation companies, and local utilities.

Up to 1800 the public opposed corporations because they were monopolistic. The early grants of charter privileges to the trading companies of England, it will be recalled, conferred a monopoly of trade on each company in a certain section of the world. But these monopoly powers were often used oppressively, the companies jealously guarding their exclusive privileges and at the same time making it difficult for new members to enter the company. Consequently the public associated the corporation with monopoly and special privilege. In 1688 the people of Massachusetts protested to the king against the granting of a charter incorporating a trading company with power to open mines in New England. Their objection was that such charters tended to create monopolies and to enhance prices. In 1717 the legal advisers of the king opposed the incorporation of a marine insurance company as a dangerous experiment, and the charter was finally granted three years later only after evidence had been presented to show that one hundred fifty private insurers had failed.[9]

IV. The Corporation Becomes the Prevailing Form of Organization

The corporation has gradually lost association with the idea of monopoly. One of the important reasons for the change in attitude is that it is no longer necessary for the legislature to pass an act of

[9] Edgar H. Farrar: Address before American Bar Association, 1911. Reprinted in *Hearings of Committee on Interstate Commerce*, 1913, Vol. I, p. 1523.

incorporation for each charter granted. The earlier method, known as special incorporation, has given way to general incorporation. By general incorporation is meant the enactment of a general law prescribing the method of incorporation and the powers and other attributes of corporations that may be formed, and authorizing the secretary of state or some other state official to issue charters. Special incorporation was found to result in favoritism and also to consume the time of the legislature in routine activities.

The transition from special incorporation to general incorporation came slowly. The change required several centuries for its consummation, for the legislatures feared that evils would result from general incorporation. The first experiment with general incorporation was conducted in England on a limited scale in 1597. In that year a statute was passed providing that during the ensuing twenty years anyone might form a corporation for founding one or more hospitals, abiding places, or houses of correction. This statute was the result of an emergency arising from the dissolution of the monasteries and the confiscation of the lands of the church.

In America, also, the privilege of general incorporation was at first extended only to certain types of enterprise. The constitution of South Carolina, adopted in 1778, granted freedom of incorporation for religious purposes to Christian Protestant churches. Soon after the Revolution, New York, New Jersey, and Delaware passed laws providing for the incorporation of societies formed for religious purposes, and New Jersey soon expanded the provisions of the act to include societies formed for literary and charitable purposes.

The first state to offer incorporation for business purposes to any who desired it was North Carolina in 1795. However, the privilege was restricted to canal companies, and the privilege was further qualified by the provision that the entire enterprise should become public property when the shareholders had received a return of their capital with interest at six per cent. Massachusetts made incorporation of water companies free to all upon equal terms in 1799. The first state to grant general incorporation for manufacturing purposes was New York in 1811. The other states followed with similar laws, but only very slowly; and it was not until about 1860 that such laws became general.

Incorporation by special statute is now prohibited. Not only was incorporation made easy by general incorporation laws, but incorporation by special statute was forbidden. Thus, in 1845 the constitution of the state of Louisiana was amended to forbid the

creation of corporations by special laws, except for political or municipal purposes and for banking. The legislature was directed to provide by general laws for the organization of all other corporations. In 1846 Iowa provided that both public and private corporations should be created by general laws only and not by special laws. New Jersey adopted a similar provision in 1875. Other states, also, recognizing the abuses that arose from requiring each corporation to secure its charter from the legislature, amended their constitutions to prohibit the legislature from granting incorporation by special law.

Corporation laws have gradually been made more liberal. The first general incorporation laws restricted the powers which might be conferred upon corporations and the purposes for which a corporation might be organized. Single-purpose corporations were, in fact, the rule. One corporation could not own shares of stock in another, and there were various restrictions upon the issue of stock. For instance, the New York general incorporating act of 1811 limited the capital of each corporation organized under its provisions to $50,000 and the duration of the charter to five years. Unlimited liability was also generally imposed upon the shareholders by the state corporation laws. These restrictions have been removed, one by one, until now most states permit corporations to be formed in perpetuity, with limited liability of shareholders, with very broad corporate powers, and with almost any amount of authorized capital divided into different types of shares, possessing whatever rights to participate in dividend and asset distributions the incorporators see fit to attach to each class of stock.

The tendency to liberalize incorporation laws has continued to the present time. Since 1930, a number of states which were formerly regarded as conservative have revised their incorporating acts to make them more liberal. Under the new legislation a corporation may be authorized to purchase its own shares. It may have unrestricted authority to purchase and in some instances to guarantee the securities of other corporations. In Michigan, only one incorporator is required, and he may be either a natural person or a corporation. The corporation may sell its entire assets without the unanimous consent of its shareholders which was formerly required, a simple majority or a two-thirds majority now being sufficient. In many states, the giving of public notice that the business is a corporation is no longer required as a part of the incorporation process, and the life of the corporation begins as soon as the articles

of incorporation are filed with the secretary of state or as soon as the fees are paid. The corporation may possess vast powers in carrying on its business, and the powers to issue new securities and to borrow money are greatly increased. The requirement that the incorporators and directors must reside within the state has also been dropped in many cases.

The growth of trade and manufacture greatly encouraged the use of the corporate form. In the United States, manufacturing increased rapidly during the years 1850 to 1900, and there was a similar development of transportation and commerce. Because the corporate form facilitated the raising of capital, the corporation was the favorite form of organization for large enterprises engaged in manufacture, the promotion of canals and railways, insurance, banking, and trading operations. The corporation is the dominant form in such fields of manufacturing as metals, oil, food products, beverages, tobacco, printing and publishing, textiles and textile products, leather, lumber, and chemicals. It is important in mining, construction, banking, real estate, amusements, and hotels. It has invaded business activities formerly regarded as the exclusive domain of the single proprietorship and the partnership, such as merchandising, agriculture, baking, laundry service, cleaning and dyeing, and even the professions. In fact, it is difficult to think of any business activity in which the corporation is not an important form of organization.

The corporation has frequently been used as a form of organization for the financial and business activities of the government. In 1903 the United States Government acquired all of the stock of the French Panama Canal Company which owned the Panama Railroad Company. The railroad company, chartered in 1849, owned the railroad across the Isthmus. In addition to the railroad, the company now owns a steamship line operating between Panama and New York, also farms, hotels, commissaries, coaling stations, and other services in Panama. The government also owns the Alaska Northern Railway Company which was acquired by virtue of an act of Congress authorizing the President to build and operate railroads in Alaska.

During the First World War, there was a marked development of the government-owned corporation. Among the corporations organized at that time were the United States Grain Corporation, the United States Emergency Fleet Corporation, the United States Housing Corporation, and the War Finance Corporation. These

and other corporations formed at that time to conduct war activities have been liquidated or are in process of liquidation. In 1923 the government organized the Federal Intermediate Credit Banks to make loans to farmers for periods of three to five years, and in 1924 it formed the Inland Waterways Corporation to take over the operation of steamboat lines on the Mississippi and other rivers. A few other corporations were organized during the decade of the thirties, the most important of which was the Reconstruction Finance Corporation which is commonly referred to as the RFC.

During the Second World War there was a further extension of the device of the government-owned corporation. The Reconstruction Finance Corporation was greatly enlarged, and several additional corporations were organized with the RFC owning their stock. The companies owned and controlled by the RFC include the Defense Plant Corporation, Defense Supplies Corporation, Metals Reserve Company, Petroleum Reserves Corporation, Rubber Development Corporation, Rubber Reserve Company, War Damage Corporation, Federal National Mortgage Association, and the R.F.C. Mortgage Company. Other well-known government-owned corporations are Tennessee Valley Authority, Federal Home Loan Banks, and Federal Public Housing Authority.[10] However, many business activities of the government are not incorporated but are conducted by a bureau or other agency. This is true, for example, of the postal services, the postal savings banks, the government printing office, the bureau of engraving, the national parks, the Panama Canal, and war-risk insurance for veterans.

Some government-owned corporations are organized under special acts of Congress and others are incorporated under the laws of the states or the District of Columbia. At meetings of stockholders, the stock is voted for the government by certain designated officials. The directors elected at such meetings choose the officers of the corporations and formulate policies within the framework of the principles embodied in laws of Congress. Each corporation is subject to the control of a supervising agency, such as the War Department, or the Department of Agriculture. Some are independent agencies not under any department. Funds for the conduct of corporate affairs are supplied partly by appropriations of Congress for the purchase of stock or for loans. The corporations may also bor-

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[10] For complete list see Joint Committee on Reduction of Nonessential Expenditures: *Government Corporations.* Senate Document 227 (1944).

row in the open markets. Some of their funds are derived from the reinvestment of profits or the sale of properties. Income may be paid to the government as dividends or retained as a reserve fund for emergencies. Government-owned corporations may sue and be sued as separate entities, though some courts hold them to be agents of the United States and therefore not liable to suit without their own consent. Thus, some courts hold them to be separate entities, while others consider them to be mere departments or agencies of the United States Government.

Government-owned corporations have had much freedom in the management of their financial affairs. If they can pay their expenses out of revenue, they have no need to ask Congress for appropriations. They have made their own budgets, and they can make loans and borrow and spend money as they see fit. During the war period, some of them borrowed and expended enormous amounts of money with no necessity for a public accounting. Their accounts were not audited by the Government Accounting Office and many of them published no reports of their activities. An added complication is the ownership of one corporation by another, together with numerous borrowing and lending activities between corporations.

In 1945 measures were proposed to bring government corporations under control of Congress. A law was enacted in February which provides for the audit of their accounts by the Government Accounting Office. Late in 1945, a bill known as the Byrd-Butler Bill was pending which was designed to establish complete control over their activities. It provided that each corporation must prepare a budget of its proposed activities to be submitted to the Bureau of the Budget and, after approval, to be transmitted by the President to Congress. It would prohibit the expenditure of any funds or the making of any loans except from appropriations made by Congress. Unexpended balances would revert to the general funds at the close of the fiscal year just as they do for any other government agency. Regular audits were also contemplated to assure that all disbursements were in accordance with the laws of Congress. The bill was passed in December, 1945.

The corporation is used for activities other than business. Although in this book we are concerned principally with business corporations, it is well to remember that the corporation is a common device for organizing many kinds of activity. It is found in such governmental organizations as cities and counties and in many

social, professional, educational, and religious organizations not conducted for profit. A classification of corporations would include the following:

I. Public corporations created for public purposes.
   A. Political nonstock corporations, as:
      1. Cities.
      2. Towns.
      3. Counties.
      4. Levee districts.
      5. Drainage districts.
      6. School districts.
   B. Stock corporations owned and controlled by the government, as:
      1. Financial corporations.
      2. Transportation companies.
      3. Corporations for war activities.
      4. Corporations for development and relief.

II. Semipublic corporations, privately owned but performing public functions.
   A. Public utilities, as:
      1. Railway corporations.
      2. Telephone companies.
      3. Telegraph companies.
      4. Gas companies.
      5. Street railway companies.
      6. Light and power companies.
   B. Finance corporations, as:
      1. Banks.
      2. Trust companies.
      3. Insurance companies.

III. Private corporations, privately owned and conducted for private purposes.
   A. Stock corporations conducted for profit, as:
      1. Manufacturing corporations.
      2. Mercantile companies.
      3. Investment trusts.
   B. Nonstock, nonprofit corporations organized and conducted by groups of persons, as:
      1. Colleges.
      2. Churches.
      3. Research organizations.
      4. Hospitals.
      5. Fraternities.

Questions

1. How is the corporation associated with the assumption of liabilities? With the ownership of rights?
2. What uses did the Romans make of the corporation?
3. How did the Roman corporations differ from modern corporations?
4. How did the first municipal corporations originate in England?
5. Where did the church get the power to create corporations?
6. What attributes did the early business corporations borrow from the municipal corporations?
7. What was the practice of "splitting stock"? How did it differ from a stock split-up by a present-day corporation?
8. Why should a stockholder have one vote for each share held?
9. If a stockholder does not attend a meeting of stockholders, should he be permitted to authorize someone else to vote for him?
10. How was the theory of the corporate entity affected by the doctrine of the divine right of kings?
11. From what four sources were charters procured in America during the days of the colonies?
12. What types of corporations may now be created by Congress?
13. What kinds of business enterprises were incorporated during the years 1789 to 1800?
14. Why were early corporations thought of as monopolies? Why are they not thought of as monopolies to-day?
15. What is meant by special incorporation? What abuses grew out of that method of incorporation?
16. What is meant by general incorporation? Why were governments at first afraid of general incorporation?
17. In what respects have incorporation laws been made more liberal?
18. What are the advantages in incorporating a branch of business or financial activity of the government?
19. Mention some of the business or financial activities of the government that are not incorporated. Why are they not incorporated?
20. What control is exercised by Congress or the Government Accounting Office over government corporations?
21. What difference does it make whether the courts regard a government-owned corporation as a separate entity or an agency of the government?
22. In the computation of the amount of the public debt, should the obligations of government-owned corporations be included?
23. What is a semipublic corporation? Is an ice company a semipublic corporation? A corporation engaged in meat-packing? What difference does it make how a corporation is classified?

24. Municipalities and counties are sometimes referred to as quasi-corporations. What does this name mean?

25. A college fraternity wishes to acquire a lot and a house. None of the members or officers are willing to assume liability for payment of the mortgage note which must be issued in part payment for the property. Suggest a method of organization whereby none of the members may be required to assume personal liability for the note. Compare the nonstock corporation and the business trust for use in this instance.

26. Compare the business trust and the corporation in the following respects:

a) Name of contract to form.
b) Names of parties making the original contract for formation.
c) Duration.
d) Kinds of shares which may be issued.
e) Name of shares of ownership.
f) Name of holders of shares.
g) Managers of each.
h) How compensation of the board is determined.
i) How vacancies in the board are filled.
j) Principal advantage.
k) Principal disadvantage.

CHAPTER VII

Theories of the Corporation

During the history of the corporation, there have been many changes in its nature, in the uses made of it, and in the public attitude toward it. As might be expected, it is still in process of development, and some of its characteristics are still the subject of dispute. In the present chapter, let us consider the nature of the corporation and the theories which have been advanced to explain it. The legal-entity theory is the most widely accepted and requires more thorough discussion than the others.

I. The Legal-Entity Theory

The statement that the corporation is a legal entity means that it has the rights of a person so far as the law is concerned and that the courts recognize it as a person. The corporation is not a real or natural person, but is considered a legal person for certain purposes. In other words there are two kinds of persons, natural persons and fictitious or legal persons. The corporation is the only example of the fictitious person.[1]

While most definitions of the corporation emphasize the idea that it is a fictitious person, they do not all emphasize the same attributes. One of the earliest definitions of the corporation was that of Sir William Blackstone, who said in 1765 that the corporation is an artificial person created "to maintain a perpetual succession and enjoy a kind of legal immortality." [2] The purpose, according to Blackstone, was "to preserve entire and forever those rights and immunities, which, if they were granted only to those individuals

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[1] A single individual acting in an official capacity, such as a bishop or a king, has sometimes been personified as a corporation and is spoken of as a corporation sole. Most legal writers contend, however, that one human being is only one legal person even though he may act in several capacities. See F. W. Maitland: "The Corporation Sole," *Law Quarterly Review*, Oct., 1900, Vol. 16, pp. 335-354; and "The Crown as a Corporation," *Law Quarterly Review*, April, 1901, Vol. 17, pp. 131-146.

[2] William Blackstone: *Commentaries on the Laws of England,* I, p. 467.

of which the body corporate is composed, would upon their death be utterly lost and extinct." Blackstone considered the principal characteristic of the artificial person to be unlimited life, that is, the right to hold property and to continue to conduct its business regardless of what happened to the individual shareholders. This was the prevailing view of the corporation until recent years, when the emphasis was gradually shifted to the idea of limited liability.[3]

The most famous definition of the corporation is that given by Chief Justice Marshall in the famous Dartmouth College case (1819):

"A corporation is an artificial being, invisible, intangible, and existing only in contemplation of the law. Being a mere creation of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence. . . . Among the most important are immortality and, if the expression may be allowed, individuality, properties by which a perpetual succession of many persons are considered as the same, and may act as a single individual. They enable a corporation to manage its own affairs, and to hold property without the perplexing intricacies, the hazardous and endless necessity of perpetual conveyances for the purpose of transmitting it from hand to hand."[4]

The principal characteristics of the corporation result from the fiction that it is a separate person. These are:

1. The corporation has many of the legal rights of a natural person. It can sue and be sued in its own name, and it is not necessary to join any or all of the stockholders in a suit. A stockholder may sue the corporation in which he owns stock without being both plaintiff and defendant at the same time. In the same way the corporation may sue its own stockholders. If the corporation is sued by another business or person, the stockholders may not offset debts due them from the other business; but the corporation must pay its debts in full, and the stockholders in turn may demand the payment of the debts due them. If a stockholder sees that his corporation is being defrauded, he cannot take action directly even

[3] Edward Coke said of the corporation: "This is a body to take in succession, framed (as to that capacity) by policie, and thereupon it is called by Littleton a body politike; and it is also called a corporation, or a body incorporate, because the persons are made into a body, and are of capacity to take and grant, etc." (*Commentary upon Littleton,* Sec. 250. London, 1785).

[4] 4 Wheaton 518, 636.

though he owns all of the stock; any legal action must be taken in the name of the corporation, for the corporation, not the stockholders, owns the business property. Again, the corporation has the right to own and convey the title to property in its own name. Both the property of the corporation and the corporate stock may be taxed, for both the natural person and the corporate person are subject to taxation. A stockholder receives no income from the earnings of the corporation except as it is paid to him as dividends, and if the dividends are in the form of stock, he still has had no income.[5] A stockholder is not liable for the acts of a corporation even if he owns all of its stock.[6]

2. The second characteristic of the corporation resulting from the fiction of the artificial person is the limited liability of the stockholders. As the debts of the corporation are the debts of the separate legal person, the stockholders cannot be held for them under ordinary circumstances.

3. The third characteristic of the corporation is that its life is not affected by the sale or transfer of its stock. The stock of a large corporation which is traded on the stock exchanges may change hands every few minutes of the day, but the life of the corporation is unaffected. All of the stockholders of a corporation might die or become bankrupt without affecting the corporation. The modern corporation with its continuous existence, despite its changing membership, has been compared with a river which retains its identity even though the parts which compose it are constantly changing.[7]

4. The fourth characteristic of the corporation is that the stockholders are not its agents unless they are authorized by the corporation to act as such. The members of a partnership, as we have seen, are free to act as agents of the partnership concerning matters which fall within the scope of the business. Stockholders in a corporation, however, have no power to bind the corporation. The corporation, as a separate legal person, has the privilege of choosing its own agents. And this is an exceedingly important characteristic; without it, the corporation could not safely permit its stock to be widely held.

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[5] Eisner *v.* Macomber, 252 U.S. 231 (1920).

[6] General Motors Corporation *v.* Moffet, 160 N.E. 878 (Ohio, 1927); C. L. and L. Motor Express Co. *v.* Achenbach, 82 S.W. (2d) 335 (Ky., 1935); Noth *v.* Higbee Co., 3 N.E. (2d) 391 (Ohio, 1936).

[7] This apt comparison was made by Blackstone; *op. cit.*, I, 468.

not a person of color even though its shareholders are colored. This peculiarity of the corporate person is illustrated by an incident which occurred in Virginia. A man sold a piece of land with the provision in the contract of sale that it should never be sold to a person of African descent or to a colored person. The land was later sold to a corporation in which all the stockholders, directors, and officers were colored persons, and they turned it into an amusement park for colored people. But since the corporation is a separate person, the fact that the stockholders were persons of color had no effect upon the corporate personality. The property had not been sold to a person of color, because the corporation can have no color.[9] This case, however, is probably the minority view as many courts have held to the contrary.

Whether or not a corporation is an alien enemy in time of war, however, may depend upon whether the corporation's officers are alien enemies. Thus, an English corporation, whose shareholders and officers were alien enemies, was held by the British House of Lords in 1916 to be an alien. It was said that "the acts of a company's organs, its directors, managers, secretary, and so forth, functioning within the scope of their authority, are the company's acts and may invest it definitely with enemy character. It seems to me that similarly the character of those who can make and unmake these officers, dictate their conduct, mediately or immediately, prescribe their duties and call them to account, may also be material in a question of the enemy character of the company."[10] The opposite view was expressed in other cases decided in the United States at the same time, the corporation being held to be a citizen of the country which granted its charter regardless of the domicile of the incorporators or the stockholders.[11]

In many respects the corporation cannot be treated as a person. For instance, the corporation cannot take an oath. In the administration of estates by trust companies and in the performance of other duties, the oath may be taken by the officers or it may be waived. The corporation, though a legal person for some purposes, has no right to vote. It cannot be put in jail for its crimes: its punishment must be limited to imposing a fine upon it, or to ordering it to surrender its charter and to submit to its dissolution; or,

[9] Peoples Pleasure Park *v.* Rohleder, 109 Va. 439, 61 S.E. 794 (1908).

[10] Robert S. Stevens: *Handbook on the Law of Corporations,* p. 58. West Publishing Company, St. Paul, Minn., 1936.

[11] Fritz Schulz, Jr., Co. *v.* Raimes and Co., 166 N.Y. Supp. 567 (1917).

in the case of foreign corporations, punishment must be limited to ousting it from the state and thus depriving it of its privilege of doing business; or inflicting fines upon it. The corporation cannot marry or be divorced. It cannot personally appear in court, and its officers cannot appear and answer for it unless they are attorneys.[12] This is the usual view, but to add to the confusion some courts have held that an officer of a corporation may appear in court for the corporation just as any natural person may appear in his own behalf.

The corporate person frequently lacks certain rights which the natural person possesses. The states may grant to corporations any power which they choose, but they frequently fail to grant them certain rights. The most important such rights are as follows:

1. *The right to enter a partnership.* The nature of the partnership is foreign to the theory of the corporation. The stockholders of a corporation elect a board of directors and delegate to them the power of managing its affairs. If the directors in turn enter a partnership, they delegate a part of the powers of management to some one else. Since every partner can represent the firm and make contracts in its name, the directors would find if they entered a partnership that they had lost control over the business of the company. Partnerships of corporations are also objected to, on the ground that they might lead to combinations in restraint of trade.

2. *The right to make accommodation endorsements.* While a natural person may endorse promissory notes or other obligations as an accommodation for a friend, a corporation may not legally do so. It is not permitted to endorse for a customer if the purpose is merely to secure his goodwill. It may endorse if necessary to make a sale or to keep a customer in business. It can endorse notes received from customers if endorsement is necessary to discount the paper at a bank.

3. *The right to lend money.* Lending money is a power of a bank, and industrial corporations are usually not permitted to exercise banking privileges. Corporations do sometimes lend money, but they do so under the guise of investing surplus funds.

4. *The right to acquire its own stock, in some states.* The right of a corporation to purchase its own shares may be implied when the position of neither creditors nor shareholders will be impaired.[13]

[12] Brandstein *v.* White Lamps, 20 Fed. Supp. 369 (1937).

[13] Robert S. Stevens, *op. cit.*, p. 242.

There are a number of ways in which such other groups may be affected. First, the capital fund which the corporation holds for the protection of creditors may be impaired. Second, the share of the assets to which stockholders are entitled at the dissolution of the corporation may be reduced. Third, the relative voting power of shareholders may be affected. The purchase of its own stock may also cause the corporation to embark upon a speculation not originally contemplated by the shareholder, and it may cause the officers and directors to undertake to rig the market price of the shares.

5. *The right to practice the learned professions.* The reason the corporation may not usually practice the professions is that the relation of the professional man to his patient or client is personal, whereas the corporation is impersonal. The corporation, which is an intangible artificial being, cannot have personal relationships. The patient or client employs his doctor or lawyer, for example, because of his confidence in him as an individual; if a doctor or a lawyer is employed by a corporation, his position is dependent upon the approval of the corporation and not upon the approval of the client. This situation is not designed to develop the ideal of the fidelity of the doctor to his patient or of the lawyer to his client. Doctors and lawyers by the ethics of their professions are not permitted to advertise or solicit business but corporations may do so. Moreover, the person who wishes to become a doctor or a lawyer must undergo a long course of study in preparing for his profession, and he must pass a state examination before he can engage in public practice. The corporation obviously cannot do this.

Corporations have in many instances been required to cease the practice of the professions. Thus, an insurance company issuing a policy of health insurance which provided for the rendering of medical attention by physicians selected by the company was held to be practicing medicine without authority.[14] In a similar case an automobile club, as an incident to membership, paid for legal services in connection with suits involving the members' use of automobiles. Even though each member was entitled to select his own counsel, the court held that this involved the unlawful practice of law by the corporation.[15] However, a corporation may practice optometry, which in many states is held not to be a profession but

[14] Benjamin Franklin Life Assurance Co. *v.* Mitchell, 58 Pac. 2d 984 (Calif., 1936).

[15] *In re* Maclub of America, 3 N.E. 2d 272 (Mass., 1936).

a mechanical art requiring manual dexterity and a knowledge of the use and application of certain instruments.[16]

Corporations have encroached upon the fields of professional men. Despite legal prohibitions, corporations often do what is in fact professional work. In the field of law, they search and guarantee titles to land, write wills and deeds of trust, prepare tax returns, administer estates, secure charters for businesses wishing to incorporate, and act as collecting agencies. Most of this work is not done by incorporated professional firms but by corporations, organized principally for other purposes, which hire lawyers for certain types of work. Corporations, in fact, possess important advantages over the individual lawyer because of their continuous life and responsibility, their financial strength, and their ability to employ a specialized staff of legal advisers. Many persons contend that the states should frankly recognize the fact that corporations actually do practice law and should undertake to regulate corporate legal practice.

Accounting corporations may be formed in a few states. Accounting service has been made less personal than it once was by the addition of such activities as personnel supervision, system building, management engineering, budgetary control, and corporate reorganization, as well as income-tax work and auditing. The basis of the work is still accounting and the service retains a personal element, but it is not so personal as it once was. In a few states corporations may be organized to practice architecture and to conduct hospitals and clinics, provided the work is done by persons who are properly trained and licensed to practice.

II. Difficulties Arising from the Legal-Entity Theory

Although the fiction that the corporation is a person is useful for some purposes, it is subject to abuse. Strict adherence to it would in many cases work an injustice to individuals or would be to the disadvantage of the government. In many cases the courts have been unable to adhere to it.

The legal-entity theory has resulted in the development of the one-man corporation. The one-man corporation is one which is formed and operated for the benefit of one person or a small group of persons, or a family. Such corporations are easy to organize because the acquisition of all of the stock by one person does not end

[16] Dvorine *v.* Castelberg Jewelry Corp., 185 Atl. 562 (Md., 1936).

the life of the corporation even though three incorporators may be necessary. If three directors are necessary and if each director must own one share of stock, the owner may simulate compliance with the law by registering one share each in the names of two persons who serve as "dummy stockholders" and "dummy directors." Such persons must agree to transfer to the owner all dividends received; and if they cease to be directors, they must transfer their stock to other persons designated by the owner.

When one person controls a corporation, he operates in an atmosphere of make-believe in order to comply with the law. He treats the company as though it were something apart from himself. At a meeting of stockholders, he elects himself and his representatives to constitute a board of directors. All actions of the board are designed to comply with the law. It elects the owner to be president of the corporation, confirms contracts, and declares dividends. The owner, as president, conducts all business in the name of the corporation. Thus, one person may act as stockholder, director, and officer; and he is careful to indicate the capacity in which he is acting as he carries on various corporate activities.

The courts consider the one-man corporation not a corporation but a natural person if they find it equitable to do so. This result is achieved by saying that the corporation is the "alter ego," the "nominal identity," or the "instrumentality" of the stockholder.

The fiction of the corporate person has been disregarded where necessary to effect justice or carry out public policy. Even though a corporation is not controlled by a single stockholder, the courts will disregard the fiction of the corporation, or "pierce the corporate veil," as it is sometimes called, if they find the fiction contrary to the public interest. Courts of equity look upon the corporation as a legal person only so long as justice is accomplished by so doing, and they refuse to do so if they find that the corporate form is used as a cloak for fraudulent or other wrongful acts.

1. *The corporate fiction has sometimes been disregarded where it was used for fraud.* It has long been agreed that if a sole stockholder sets fire to corporate property to obtain the insurance, the corporation will be denied the right to recover on the insurance policy. In most cases of fraud, the owners of property have transferred it to corporations for the purpose of hindering private creditors. Subsidiary corporations have sometimes been created for the express purpose of transferring property to them in order to con-

fuse and delay creditors. Where this has been done, the courts have frequently gone behind the form of the transaction and looked at the substance.[17] For example, a corporation in Missouri, unable to procure credit from a bank because of an unsatisfactory ratio of current assets to current liabilities, organized a subsidiary to act as its sales agent. It transferred to it certain assets and a few liabilities, and the subsidiary negotiated a loan. The parent company owned all of the stock of the subsidiary, and the two corporations had the same officers and directors. However, the businesses were kept separate as far as the corporate formalities were concerned. When the parent company failed, the receivership was extended to the subsidiary as an instrumentality of the parent.[18] In one case involving the transfer of property to a corporation in which the owner of the property was also the principal stockholder, the court said that the identity of the owner was no more changed by the transfer of title to the company than it would have been by his taking off one coat and putting on another.[19]

The instances in which the corporate fiction has been disregarded on account of fraud are not so clearly departures from the theory of the corporation as are some other cases, for they usually have involved a fraudulent transfer of property which made the transactions illegal on other grounds.[20]

2. *The corporate fiction has been disregarded where it is used to evade the law.* For example, in 1903 Congress passed the Elkins Act, making it illegal for a common carrier engaged in interstate commerce to give rebates of freight charges, and for shippers to receive rebates. Prior to the enactment of the law a brewing company which was a large shipper of beer had regularly received a rebate from the railways of a part of the freight charge. Shortly after the enactment of the law, it organized a transit company which

[17] The following statement of the law was made by Justice Sanborn: "A corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons." (U.S. *v.* Milwaukee Refrigerator Transit Co., 142 Fed. 247 (1905).) For further discussion, see *Regulation of Stock Ownership in Railroads,* House Report 2789, 71st Congress, 3rd Session, 1931, Vol. I, pp. 8 ff.

[18] Woodbury *v.* Pickering Lumber Co., 10 Fed. Supp. 761 (1931).

[19] First National Bank of Chicago *v.* Trebein Company, 59 Ohio 316 (1898). See also Hayhurst *v.* Boyd, 300 Pacific 895 (Idaho, 1931).

[20] For a case involving the transfer of property to a corporation in which the corporate entity was disregarded because its observance would work an injustice upon the stockholder, see Miller *v.* Tax Commission of Wisconsin, 195 Wis. 219, 217 N.W. 568 (1928).

it authorized to act as its shipping agent. Through the transit company, the brewing company contracted with the railways for shipments of beer, and the railways agreed to pay a percentage of the freight charge to the transit company. This was ostensibly a commission for obtaining the business, but in fact it was a rebate for the benefit of the brewing company. The court looked at the substance of the arrangement and declared that the transit company was a mere separate name for the brewing company.[21]

In tax cases the general rule is that the corporation is recognized. Thus, sales of securities by a shareholder to a corporation in which he owns stock are *bona fide* sales, and losses may be reported for tax purposes. Taxpayers cannot deduct for tax purposes the losses of their one-man corporations. A sole stockholder who received securities owned by his company in exchange for stock which he surrendered and who later sold the stock was held to have owned the stock only from the date of transfer to him and not from the date of purchase by the corporation.[22]

In many tax cases the courts have held that the corporation is not a separate entity but is only a device whereby the owner divides his property into salable units. Thus, when a person transferred property to a one-man corporation which later returned it to him, the courts held that the shadowy transactions did not affect the real nature of the ownership.[23] In another case, a person who had been defrauded in the purchase of stock transferred the stock to a corporation created for the purpose of accepting the transfer. The corporation settled for $100,000 which was to be paid to the sole stockholder over a period of forty years. The purpose was to avoid taking all of the loss in one year, but the owner was taxed as if he had received the entire sum at one time.[24] Usually gains created by exchanges of property in pursuance of corporate reorganizations are not recognized for purposes of taxation until the stock is sold; but if a corporate reorganization is effected for the purpose of avoiding a tax, the court will disregard the corporate entity and treat the transaction as if the title to the assets had been transferred directly to the stockholder.[25] The view of the court is summarized in the following statement:

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[21] U.S. *v.* Milwaukee Transit Co., 142 Fed. 247 (1905).

[22] Webber *v.* Knox, 97 Fed. (2d) 921 (1938).

[23] Law *v.* McLaughlin, 2 Fed. Supp. 601 (1933).

[24] Griffiths *v.* Commissioner of Internal Revenue, 308 U.S. 355 (1939).

[25] Gregory *v.* Helvering, 293 U.S. 465 (1935).

"The government may not be required to acquiesce in the taxpayer's election of that form of doing business which is most advantageous to him. The government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supersede legislation in the determination of the time and manner of taxation." [26]

If the owner of a large block of bank stock organizes a corporation to take title to the stock as his mere agent or instrument, he will be liable under the double-liability provisions of the National Bank Act as though he owned the stock of the bank directly.[27]

Other instances in which the theory of the corporate entity has been disregarded because it was being used to evade the law, involved the attempt of the railway companies to evade that provision of the Hepburn Act which states that a railway company cannot transport for sale any article manufactured or mined by it or in which it has an interest. The railway companies attempted to evade the law by three different methods, all of which were unsuccessful. One railway company formed a subsidiary coal company which mined and shipped the coal. The railway company contended that it did not own the coal, but the court held that the coal company was a mere department of the carrier.[28] Another railway company created a sales company which was independent in accounting system, assets, and operating force, but not in executive officers. The sales company contracted to buy the coal prior to shipment, the coal being mined by the railroad company or a subsidiary mining company. Since the sales company was subject to the will of the carrier, it was held to be a mere sales agency. A third attempted plan of evasion was for both the railway company and the coal company to be organized as subsidiaries of a holding company. Since neither subsidiary company was free to formulate and execute its own policies, however, the railway and the mining properties were held to be owned by the same company.[29]

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[26] Higgins *v.* Smith, 308 U.S. 473 (1940).

[27] Nettles *v.* Rhett, 20 Fed. Supp. 486 (1937).

[28] United States *v.* Lehigh Valley Railroad Co., 220 U.S. 257 (1911); U.S. *v.* Reading Co., 253 U.S. 26 (1920).

[29] "The Commodities Clause," *Harvard Law Review,* Dec., 1936, Vol. 50, pp. 322-332.

Recently, the question of whether an industrial company which owns all of the stock of a railroad company comes within the provisions of the Hepburn Act has been considered by the courts. The United States Steel Corporation, some of whose subsidiaries mine and ship coal, owns all of the stock of a number of railway companies, one of which is the Elgin, Joliet, and Eastern Railway Company. It was held by the United States Supreme Court that the subsidiaries of the United States Steel Corporation were independent corporations and not mere departments of the parent company. This decision was based upon the absence of common directors, the keeping of separate accounts, the ownership by the railway company of all the equipment which it needed, and the rendering of fair service to all patrons of the railway without discrimination.[30] A minority of the court held, however, that the fiction of the corporate person should have been overlooked and that the parent and its subsidiaries in reality were but a single company. The dissenting opinion pointed out that the officers of the railway company were selected by the parent and that they confirmed all contracts made for them by the parent, that dividends were declared by the directors of the railway company only when the United States Steel Corporation gave its consent, that the railway company made payments to the other subsidiaries through the parent company at terms fixed by it, that the holding company's consent was required for all expenditures of more than $5,000, and that the parent company used the surplus funds of the subsidiaries.

The corporate fiction will not be disregarded for the benefit of the corporation or its stockholders. In many instances, corporations have claimed exemption from various taxes or regulations of the government on the ground that a corporation whose stock is owned by another is not a separate entity but a department of the larger company. Such attempts generally fail. For example, a coal company was owned by a railroad company and sold all of its output of coal to the railroad company. The coal company claimed exemption from the sales tax on the ground that such sales were only transfers from one department to another, which for many purposes would be the correct view. The court overruled the contention for tax purposes. It said:

"Where corporations meticulously observe the formalities incident to separate corporate existence and receive substantial eco-

[30] United States *v.* Elgin, Joliet, and Eastern Ry., 56 Sup. Ct. 841 (1936).

nomic benefits therefrom, they will not be permitted to disregard the distinction for the purpose of avoiding the burdens likewise incident to the maintenance of separate corporate entities. . . . Having utilized separate corporate forms for nearly two years, having undoubtedly secured financial and economic advantages as a result during this period, and having consistently employed the habiliments incident to a sale, . . . we are of the opinion that the plaintiff is not now in a position to renounce its separate entity."[31]

3. *The corporate entity has been disregarded in certain damage cases.* Cattle shipped over the Rock Island and Pacific Railway System were damaged while in the custody of subsidiary corporations in the states of New Mexico, Texas, and Oklahoma. The parent company was held liable for damages throughout the system. The United States Supreme Court stated that where one railroad actually controls another and operates both as a single system, the dominant company will be liable for injuries due to the negligence of the subsidiary company.[32]

To cite another instance, the Yellow Truck and Coach Manufacturing Company owned all the stock of a managing company and a 60 per cent stock interest in four taxicab companies. The managing company owned no stock in the taxicab companies but had contracts with them authorizing it to draw their payroll checks, to maintain a central repair garage, to hire mechanics, to approve or disapprove of prospective employees, and to designate the territories of each operating company. When a person who was injured in a taxicab accident sued the managing company, it was held that the corporate entity of the four operating companies should be disregarded and the management company should be held liable.[33]

These decisions have been contradicted by a number of other decisions in which the facts were much the same. In deciding whether one corporation is a mere instrumentality of another, the courts consider such factors as: the identity of stockholders, directors, officers, and employees; the financing of the subsidiary by the parent; the control exercised by the parent over the income of the subsidiary; the identity of books and records of the two corpora-

[31] Superior Coal Co. *v.* Dept. of Finance, 36 N.E. (2d) 354 (Ill., 1941). For similar reasons a coal company could not evade regulation under the National Bituminous Coal Act on the ground that it was merely a department of the railroad company which owned its stock. Keystone Mining Co. *v.* Gray, 120 Fed. 2d (1941).

[32] Davis *v.* Alexander, 269 U.S. 114, 117 (1925). For a similar decision, see Lehigh Valley Railroad *v.* Dupont, 128 Fed. 840 (1904).

[33] Mangan *v.* Terminal Transportation System, Inc., 248 N.Y. Supp. 183 (1935).

tions; the maintenance of a separate bank account by the subsidiary and the control which it exercises over its own funds; the similarity of names and purposes; and the separation of officers.[34]

III. Other Theories of the Corporation

The theory that the corporation is a separate, legal artificial person may be said to be definitely established as a part of the law. Since the courts have found it desirable to disregard the fiction in certain cases, however, some courts have attempted to develop a theory that would in all cases be consistent and at the same time further the public interest. Two such theories are the association theory and the legal-unit theory. Though neither of these theories is widely held, both make a strong appeal. A fourth theory is the organic theory.

The corporation may be regarded as an association of persons. According to the association theory, the corporation is only a device by which natural persons employ their resources and perhaps their labor in a single enterprise. Just as they might engage in a business together as a partnership, so they may engage in it as a corporation, the corporation being nothing more than the association of the members, with certain legal powers, rights, and privileges conferred upon them by the state. The corporation cannot act except as the members act for it, and whatever the corporation does must actually be the act of a natural person. According to this theory, the corporation is not a person but a method or a device; and the purposes of the law may be accomplished by considering it as a name for a useful collection of legal relations, without any necessity for personifying it. The corporation is merely a voluntary union of persons, joined together by written articles of incorporation under legislative authority, for accomplishing some business or social purpose.[35]

The corporation has also been held to be a legal unit. This theory was adopted by the Supreme Court of Minnesota in a case

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[34] Robert W. Yost: "Liability of a Parent Corporation for the Debts of its Subsidiary," *St. Louis Law Review,* April, 1936, Vol. 21, pp. 234-252; also Sydney Saxon: "Is the Problem of Disregarding the Corporate Entity More a Question of Fact than of Law?" *St. Johns Law Review,* April, 1937, Vol. 11, pp. 294-302.

[35] For statements of the association theory, see S. D. Thompson: *Corporations* (3d ed.), Sec. 2; Bobbs-Merrill Co., Indianapolis, 1927. Victor Morowetz: *Private Corporations,* Sec. 1, Little, Brown, and Co., Boston, 1886. A good discussion of the entire problem is Norman S. Buchanan: *The Economics of Corporate Enterprise,* pp. 36-45. Henry Holt and Co., New York, 1940.

decided in 1939.[36] The case concerned a woman who had been named trustee for an estate for which she was also the life tenant, that is, she was to receive the income from the estate as long as she lived, and at her death the principal of the estate was to go to another person who is known as the *remainderman*. The principal or corpus of the estate consisted of the entire outstanding stock of several companies. The trustee caused some of the companies to sell stock to others at artificial prices in order that the corporations making the sales might show profits. The trustee caused the fictitious profits to be paid as dividends to herself as life tenant. In setting aside all such transactions, the court said:

"We reject as fundamentally unsound and obsolete the thesis that a corporation can be regarded for any purpose as a mere fiction of the law. To reduce it to a fiction and then disregard it as a fiction is to disregard nothing. A fiction cannot sue and be sued, make and perform contracts, own property, commit torts and crimes. A corporation can do all that, and so is not a fiction. So to consider it is to blind thought to all reality. A corporation is not a person, but has a legal and real individuality. Neither is it artificial save as it is a generation of the law, rather than nature. It is in simple fact a legal unit—a very real one—endowed by its creator with many of the rights and attributes of persons. It is so much *sui generis* that to attempt to define it, rather than to describe it or to enumerate its peculiar features, in terms of the law of persons, tends to obstruct rather than facilitate comprehension. Much worse is to fictionize in decisions concerning a thing about which there is no trace of the fictitious. Fiction has its place but not on the bench. Litigants, whose personal and business affairs are real, rightly expect their controversies to go to judgment on real rather than fictitious bases."

Thus the legal-unit theory holds the corporation to be an agency of the law, endowed with such rights, attributes, and privileges as the law sees fit to give it. The theory gives to the corporation only those characteristics which are in the public interest, and it makes unnecessary the denial of other rights which the corporation would have if it were a person.

The organic theory considers the corporation a separate organism. This theory, advanced by a number of German writers, holds that the corporation is not an artificial person but a real person.

[36] Clarke *v*. Bennett, 284 N.W. 876 (1939).

It is argued that the corporate person comes into existence when the group of persons is organized as a corporation, and that it does not owe its existence to the law, though its legal powers, duties, and responsibilities may be regulated by law. The corporation is considered to be a type of person, or organism similar to the family, the tribe, the fraternity, the club, or other organization. It is contended that when any group becomes associated, it gradually assumes a personality different from that of the individuals which compose it. The association may be only temporary, such as a group of persons assembled to watch a passing parade, a crew of college men who row a boat, a football team, a legislative body, or a regiment of soldiers. If such groups are associated several times, the identity of the group gradually becomes established in the minds of others as something definite and lasting.[37] If the association continues long enough, the group may become something independent of the persons who compose it, just as a house made of a number of bricks is not the same as the bricks, or a river is not the same as the molecules of water.[38] The corporation becomes a new person, an organism, which exists above the substratum of persons who compose it.

The doctrine that the corporation is a separate organism has been carried to extreme lengths by some writers. The corporation is spoken of as an animal: the chief officer is the head, and the members are the arms and legs. It is endowed with a will and a power to act. It even possesses sex: some corporate organisms, like the church, are feminine; others, like the state, are masculine. It is a separate personality, a real person and not a fiction, with a sphere of existence and a will of its own.[39]

The organic theory has had few adherents outside of Germany. The corporation is perhaps as much a real person as is the family, the club, or the fraternity, but it is difficult to conceive of these latter organizations as distinct and real persons. As one writer has said, ten men do not become one person because they associate themselves together for one end any more than two horses become one animal when they draw the same cart. It is obvious that the

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[37] Robert L. Raymond: "The Genesis of the Corporation," *Harvard Law Review*, March, 1916, Vol. 19, pp. 350-365.

[38] Arthur W. Machen, Jr.: "Corporate Personality," *Harvard Law Review*, February, 1911, Vol. 24, p. 261.

[39] For additional discussion of this theory, see James T. Carter: *The Corporation as a Legal Entity*. M. Curlander, Baltimore, 1919. Also Ernst Freund: *The Legal Nature of Corporations*, Ph.D. Thesis, Columbia University, New York, 1896.

corporation is not an organism or a real person in the ordinary meaning of those terms.

Questions

1. How does the definition of the corporation given by William Blackstone differ from that of John Marshall?

2. In what sense is the corporation a person? In what respect is it not a person?

3. Is a person the same as a citizen? Are all persons living in this country citizens? Are all citizens persons?

4. In what respects is a king a corporation? How does his position differ from that of the head of a family?

5. How is the corporation like a river? Does this comparison indicate that a corporate charter is not necessary?

6. If the corporation is a person, what attributes does it naturally have? What rights or attributes must be denied it even though it is a person?

7. A corporation is organized under the laws of Delaware for the purpose of operating a steamship line between New York and New Orleans. All of the stock, except three shares, is purchased by citizens of Germany. The coastwise trade of the United States is reserved for citizens of the United States. Is the Delaware corporation a citizen of the United States for purposes of engaging in the shipping business? Do you see that it makes any difference?

8. Why should the corporation not have the power to enter a partnership?

9. What is a profession? What is the objection to having a corporation practice medicine?

10. A university, organized as a nonstock corporation, collects an activities fee from each student; and as one of the services provided for students, it offers each student two calls by the university physician without charge whenever the need arises. Is the university engaged in the practice of medicine? Is its medical service socially desirable?

11. Does the operation of a medical clinic where free medical advice is given to needy persons constitute the practice of medicine? If the university which operates the clinic is a corporation, is its practice illegal? If a clinic is operated by a stock corporation for profit, is this an illegal practice of a profession? Is there any difference between the two cases?

12. A railway company agreed to build a spur line to the plant of a manufacturer provided it could borrow the money. The bank refused to make the loan until the note was endorsed by the manufacturer. Was this an accommodation endorsement? Could a manufacturing corporation make such an endorsement?

13. Should a corporation have the right to purchase its own stock? Why or why not?

14. Is there any social justification for the one-man corporation? Indicate some of the reasons why a person might wish to form such a corporation. If the courts recognized it for all purposes, how might a person reduce his taxes by the formation of such a corporation?

15. *A* rented a parking lot from *B* under a long-term lease which contained a clause that the lease could not be cancelled unless *B* sold the property. *B* organized a one-man corporation with himself the sole stockholder and sold the property to the corporation. Should the courts permit the cancellation of the lease by the corporation?

16. How did the organization of the railways and the coal companies differ from the organization of the United States Steel Corporation and its subsidiary railway corporations in the Hepburn Act cases? Is there enough difference to justify the holding of the first to be illegal and the second to be legal?

17. Should the transfer of merchandise from one corporation to another be considered a sale when both corporations are owned by a third company? Might such a transfer be considered a sale for some purposes and not a sale for other purposes?

18. What is the association theory of the corporation? Does it overcome the difficulties of the legal-entity theory?

19. Distinguish the legal-unit theory from the legal-entity theory?

20. What is the organic theory? Is a family an organism? A college fraternity? A football team? In each of these cases, is there something besides the individuals composing the group?

CHAPTER VIII

The Charter and By-Laws

The charter is the document which brings the corporation into existence. It also sets forth the powers, duties, and general organization of the corporation. Charters are issued under authority of a general incorporating act, the officer who acts for the state being the secretary of state or the commissioner of corporations. The nature and the provisions of the charter are now to be studied.

I. The Nature of and the Method of Procuring the Charter

The nature of the charter has changed during the history of the corporation. In Rome corporations were regulated by licenses which were issued by the emperor. Even at a much later period, charters were often imposed upon businesses for regulatory purposes. The regulatory feature is now often secondary, and more important is the fact that some states receive a substantial part of their revenues from the issuance of charters.

The charter constitutes a contract between the corporation and the state. That the corporate charter is a contract was decided in the famous Dartmouth College case in 1819, the decision being given by Chief Justice John Marshall. Dartmouth College had received its charter from the English Crown in colonial days, and the question arose whether the state of New Hampshire could modify the charter. Although the state of New Hampshire had not granted the charter, it was bound by it, for at the time of the Revolution it had succeeded to the position of the Crown and was obligated by whatever the Crown had agreed to. This doctrine is the prevailing legal theory.

The charter may be modified by the state. The doctrine that a charter cannot be modified by the state without the consent of the corporation was decided in the Dartmouth College case. It follows logically from the first principle that the charter is a contract. In practice, however, the state can modify charter provisions, for it is customary for the state to protect itself by making certain reserva-

tions which apply to all corporations: (1) The state may tax the corporation. If the state laws are changed, the revised scale of taxes applies to all corporations regardless of when the charter was granted. (2) The state may amend the charter; if the state should desire to change its corporate policies, it may do so. Since the state constitutions prohibit special incorporating acts, any changes in corporate charters by statutory enactment must be accomplished through general laws and not through laws which apply to only one or a few corporations. If this were not so, the legislature might actually pass special incorporating acts for each corporation, using the charter granted under the general laws as only the rough form for shaping the final charter. (3) The state may regulate the business. This reservation enables the state to pass laws regulating the competitive or other business practices which might be detrimental to the public interest. Even though a state has made no reservation, it is frequently held that the state may alter a charter if it is necessary to do so for the health, safety, and general welfare of the people.[1]

Congress also has the power to modify a corporate charter granted by a state if its provisions obstruct or regulate commerce among the states. Thus, a provision in the charter of the New York Central Railroad Company which had been granted by the state of New York and which provided that no more than two cents per mile should be collected from passengers was set aside under authority of Congress.[2] However, the power of either the state or the Federal government to amend charters is limited to certain purposes which are definitely remedial.[3]

The charter is drawn up by the incorporators. The procedure for procuring the charter varies according to the state, but in every state the incorporators are required to draw up a petition addressed to the proper state official, setting forth certain facts about the proposed corporation. This petition must be drawn with great care, for when it has been approved it becomes the corporate charter. Since the incorporators draw up the petition, they can place anything in it which they choose except as they are limited

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[1] "Power of the State to Alter Corporate Charters," *Columbia Law Review*, November, 1931, Vol. 31, pp. 1163-1169; Philip Gregg: "Regulation of Corporations through the Reserved Power to Amend, Alter, or Repeal the Corporate Charter," *Rocky Mountain Law Review*, February, 1937, Vol. 9, pp. 178-184.

[2] New York *v.* United States, 257 U.S. 591 (1921).

[3] Marshall County Bank *v.* Wheeling Dollar Savings Bank and Trust Co., 193 S.E. 915 (W. Va., 1937).

by state law. As might be expected, the charter often confers very broad powers, for the incorporators would rather have the corporation possess some powers which it does not use than have it need some powers which it does not possess. In most of the states the officials have drawn up suggested forms for charters, copies of which may be obtained upon application.

To the application is affixed the certificate of the notary before whom the statement is sworn and subscribed to by the incorporators. When the incorporation fees have been paid, and the application endorsed by the proper state official, the legal life of the corporation begins. The state officer who approves the charter, usually the commissioner of corporations in the office of the secretary of state, may indicate in making his endorsement that the law of the state is to be considered a part of the charter. This has the effect of notifying the corporate officers that they are expected to familiarize themselves with and to observe the state law as it relates to powers permitted to corporations, protection of the rights of creditors, declaration of dividends, and the like. One copy of the charter is kept on file in the office of the commissioner of corporations where it is open to public inspection. A second copy is filed with the recorder of deeds in the county where the corporation has its principal office in the state. A third copy, properly endorsed, is retained by the corporation.

A corporation which has fully complied with the requirements for incorporation is a de jure corporation. The legal requirements for procuring a charter are often very detailed, but they must be complied with in every respect if the corporation is to be sure of its rights and privileges. If the incorporators have filed all reports, supplied all of the information requested, and in all other respects complied with the law, the corporation is a *de jure* corporation. The phrase *de jure* may be translated as meaning "according to law." A *de jure* corporation, therefore, is a corporation which has attained its legal standing by a strict compliance with the law. Failure to attain corporate status subjects the business to the possibility of being considered a partnership and the members to the risk of being held liable for its debts.

If the incorporators have substantially complied with the law, the corporation may be a de facto corporation. A *de facto* corporation is one which has attained a corporate status in fact but not at law. If the incorporators have omitted some insignificant or unimportant step in the procedure of incorporation, such as failing

to file a copy of the charter with the clerk of a court as specified by law, or failing to acknowledge the receipt of the charter, or omitting some of the information which should be given in the application, the company may be considered as having achieved a corporate status in fact.

Before a business may be considered a *de facto* corporation, certain requirements must have been met. These are:

1. A valid law under which a corporation with the powers assumed might be incorporated must be on the statute books.
2. The incorporators must have made an attempt in good faith to comply with the law.
3. The corporation must have exercised corporate powers.

Contracts made by a corporation which proves to be only a *de facto* corporation are valid contracts, and the stockholders are not liable for the debts of the business as partners. The fact that the incorporators have not fully complied with the law is no concern of private individuals doing business with the corporation. If the incorporating act has not been complied with, the state may take action and may revoke the charter, but as against everyone but the state the rights of the corporation are protected.

The state of incorporation requires annual reports. The reports which corporations are required to make are for the purpose of facilitating the collection of taxes and the enforcement of the corporation laws. They are not intended to furnish stockholders or prospective investors with detailed information concerning the affairs of the company. The preparation of the reports may be an inconvenience, but the corporation is not required to divulge any information which might be considered confidential. For example, the annual report required by the state of New Jersey shows the following:

1. The name of the corporation.
2. The location of the office and the name of the agent upon whom legal processes may be served.
3. The character of the business.
4. The amount of the authorized capital stock and the amount issued and outstanding.
5. The names and addresses of the directors and officers and the date when the term of office of each expires.

6. The date of the next annual meeting of the stockholders.

7. A certificate that the law has been complied with in that the name of the company has been displayed at the entrance of its registered office and that the stock records have been kept as required by law.

A number of states require that the annual report show the value of the property owned within the state and the amount of business done. The purpose, however, is only to assist in the collection of taxes due the state.

II. The Provisions of the Charter and the By-Laws

The application prepared by the incorporators, which when approved by the officer of the state becomes the certificate of incorporation, usually contains the following facts pertaining to the corporation:

1. The name of the corporation.

2. The location of its principal office.

3. The objects for which the corporation is formed and the powers which it shall have.

4. The amount of capital stock and the number of shares into which the capital is divided. If more than one class is authorized, the charter contains a description of each class and the rights and privileges appertaining to each. The charter may also state whether the holder may cast all votes for directors, to which he is entitled, for a single candidate and under what conditions the stock may be assessed.

5. The maximum amount of indebtedness which may be incurred, also a prohibition against the contracting of debts in excess of that amount.

6. The duration of the corporation.

7. The officers who are to conduct corporate affairs, the duties of each, and the authority of the board of directors to fill the positions named.

8. The number of directors, the manner of their election, and their powers. The names and addresses of the directors for the first year are frequently included.

9. The names, addresses, and eligibility of the incorporators.

10. A statement of compliance with legal requirements for capital stock including the amount to be paid in before business is begun.

11. The signatures of the original incorporators.

The form and content of papers to be filed differ somewhat according to the state. Even though a simple form of financial structure is provided by the charter, it is usually advisable to seek the aid of an attorney. All questions of corporate powers, organization, and financing should be resolved before the charter is applied for. Revisions are effected only at some inconvenience and expense.

The choice of a corporate name is important. The corporate name serves to identify the corporation. It also indicates that the business is a corporation and not a partnership. Thus, some states require that the name contain the word *corporation,* or be followed by the letters *Inc.* In some states the name must begin with the word *The.* The word *company* may be used if it is not preceded by the word *and.* For example, the name John Doe and Company indicates that the business is a partnership, whereas the name The John Doe Company indicates that it is a corporation. In many states the requirement is merely that the name indicate that the business is a corporation, but the state officials may use their judgment in deciding whether a name meets this requirement.

Some states limit the use in the corporate name of such words as bank, finance, insurance, protective, and investment. These words may be used only by corporations formed in compliance with banking, insurance, railroad, and public-utility laws.

The name of a corporation or other business cannot infringe upon the goodwill of another concern. When application is made for a charter, the state officers usually attempt to learn whether some other company in the state is using the proposed name. However, the responsibility is upon the incorporators to select a name not already in use, and the officials in some states make little attempt to learn whether the name infringes upon that of another. The company which first uses a name gets prior rights to it, whether it is a partnership, joint stock company, business trust, or other form of organization. The reason is that the name becomes associated in the mind of the public with a certain company and its product, and to permit another to use the same name constitutes unfair competition against the original user and also deceives the public. Some states have enacted statutes protecting a company in the use of its name, but such protection is usually afforded by the common law.

The name which is set forth in the corporate charter must be used in all contracts of the corporation. If a different name is used, the corporation may be considered as having forfeited its charter. The persons who make contracts in a name other than the proper name of the corporation may be held to be acting as partners. If the name which is used is not intended to be a new name but merely an informal abbreviation or variation of the name set forth in the charter, it does not necessarily follow that the charter has been violated; [4] but the safest way to avoid difficulties is always to use the exact name of the company in all contracts.

A corporation may change its name by amending its charter. If a corporation finds that its name infringes upon a name used by some other corporation, or for any reason it appears desirable to change its name, it may do so without procuring a new charter. This is accomplished by procuring an amendment to the original charter, assuming that the amendment is acceptable to the state officials. A change of the corporate name does not terminate the life of the corporation any more than the change of the name of a natural person terminates his legal existence. The legal duties, responsibilities, and rights are not affected; it is the same corporation but with a different name. Frequently, instead of the name's being changed, the charter is surrendered and the company is reorganized under a new charter.

The corporation must maintain an office in the state which confers corporate privileges. The principal office of the corporation within the state of incorporation must be named in the charter and is called its residence. The reason why the residence must be in the state of incorporation is that certain fees must be paid each year and certain reports prepared, and the officers of the state must know where to find the representatives of the corporation; also, certain suits must be brought in the state which granted the charter, and notice of such suits is served on the corporation at its principal office within the state. Suits which must be brought within the state of incorporation are those seeking a dissolution of the corporation, alleging a violation of the charter or the exercising of powers not conferred by the charter, or alleging an abuse of powers by the directors.

While the state requires that the office within the state be named in the charter, it does not specify that it must be the principal place

[4] Wilhite *v.* Convent of Good Shepherd, 117 Ky. 251, 78 S.W. 138 (1904).

of business of the corporation. It permits one office to be used as the place of business of any number of corporations. The result is that in some states, particularly in the states favored by incorporators, a single trust company or other incorporating agency serves as the representative of several hundred corporations and displays the signs of all these corporations as required by law.

The powers which a corporation may exercise are prescribed by the general incorporation law. The various states, in regulating the method and procedure by which corporations may be formed, prescribe also the powers which corporations may have. The laws formerly were very rigid, permitting corporations to be formed to engage in only one kind of business. In this respect the legislatures were merely following the practice which prevailed when charters were granted by enacting a special law for each corporation to be formed. The recent tendency, however, has been to permit corporations to be formed "for any lawful purpose." Frequently the only limitation placed upon the powers of industrial corporations is that they may not engage in banking, insurance, or certain activities definitely pertaining to the public utilities. Corporations having such powers are organized under special provisions.

The fact that a corporation may be granted very large powers may lead to serious abuses. Quite often the corporation does not exercise all the powers permitted by its charter, and in fact, may not have intended to exercise all of them when its charter was drawn up. But the purchaser of stocks usually does not read the charter, though at law it is assumed that he knows what the charter contains; the result is that the investor may find himself in a business entirely different from that in which he thought he was staking his investment.

The corporation may legally exercise all powers necessary and proper to the enumerated powers. This is the doctrine of implied powers. It means that if the corporation has, in its charter, been expressly given the power to do a certain thing, say to manufacture shoes, it has by implication the power to do all things necessary and proper to the manufacture of shoes. This would include, for example, the power to purchase or lease machinery and equipment, to buy and store raw materials, to deposit money in a bank and to draw checks in payment of invoices, and similar acts. The implied powers are usually assumed to include the following:

1. *The power to contract.* This implied power includes the

power to employ workmen, to purchase materials and supplies, to repair machinery, and so on.

2. *The power to borrow money.* The money may be borrowed on unsecured notes or bonds, or the loans may be secured by the pledge of any assets of the corporation.

3. *The power to buy, own, and sell property,* provided the property is needed to carry out the express powers of the corporation.

4. *The power to make by-laws regulating the relation of the members of the corporation to each other and prescribing how the objects of the corporation are to be accomplished.*

Although these powers are usually assumed to be implied because they are necessary and proper to the accomplishment of the enumerated powers, they are, in fact, often stated in the charter. The inclusion of them with the enumerated powers removes all doubt that the corporation has the power to do those things and reduces the danger of litigation. Many charters go into great detail in enumerating the corporate powers. A clause is usually inserted declaring the corporation to have the power to do any and all things necessary for attaining or furthering any of the enumerated objects or powers of the corporation. The charter of the United States Steel Corporation adds that the corporation may "exercise any and all powers which a copartnership or natural person could do and exercise, and which are now or hereafter may be authorized by law."

Certain powers which a natural person has are not included among the implied powers of the corporation. Although the corporation is a legal person, it does not have all the legal powers of a natural person, and there are certain powers which may not be exercised by the corporation unless they are specifically granted by the charter. Most of these powers have been discussed in an earlier chapter and need only be mentioned here. They are:

1. The power to make accommodation endorsements.

2. The power to lend money.

3. The power to practice the learned professions.

4. The power to enter a partnership.

5. In some jurisdictions, the power to acquire its own stock.

6. The power to acquire shares in another corporation. State laws now permit this power to be included in the charter.

The minimum number of incorporators is specified by the statute. The usual number of persons necessary to form a corporation is three or more; a few states require five, while a small number permit less than three. No state has a requirement for a maximum number. The incorporators are normally required to be subscribers to stock, but some states do not require even this. In any case, the incorporator does not need to own more than one share. State laws sometimes permit corporations to act as incorporators for other corporations. Generally a corporation is not permitted to be an incorporator.

The requirement that three or more persons are necessary to organize a corporation may be evaded by the use of dummy incorporators. Shares of stock are nominally subscribed by persons acting for the client. They hold the first meeting of stockholders, after which time they assign their shares to the real owner. Assignment of stock after incorporation does not affect the life of the corporation.

The duration of the corporation in most states may be perpetual. Formerly it was the tendency to grant corporate charters for a limited period, with the privilege of renewal. The practice now is to specify that the life of the corporation is to be perpetual, though some states limit its life to twenty years and some to fifty. Granting a charter in perpetuity removes the uncertainty which might otherwise hinder the corporation in the exercise of its legitimate functions. The state is protected by the proviso that the charter may be forfeited through the commission of illegal acts and that it may be modified through the general incorporation laws.

Sometimes the states have failed to protect themselves in granting charters for long periods of time. Beginning about 1850, the state of Pennsylvania granted charters conferring upon various companies the privilege of operating horsecars on certain streets of Philadelphia for a period of 999 years. These companies, numbering about fifty, still exist as parts of the transportation system of Philadelphia, and their franchise rights have been frequently invoked to prevent civic improvements. The earliest of the charters will expire in 2853.[5]

The corporation may be dissolved at any time by a vote of the stockholders, provided the claims of creditors are liquidated. The life of the corporation may be terminated in any one of the following ways:

[5] *Commercial and Financial Chronicle*, July 9, 1932, pp. 182-3.

1. *By the expiration of the period for which the corporation was formed, unless the charter grants perpetual life.*

2. *By voluntary dissolution.* Formerly, unanimous consent of the stockholders was required to authorize dissolution, but under recent amendments to incorporating laws, only a three-fourths majority is necessary. In some states a simple majority is sufficient.

3. *By forfeiture of the charter to the state as a result of violation of the terms of the charter or the state laws.*

4. *By judicial proceedings,* as in bankruptcy.

The charter is supplemented by the by-laws. The corporation is regulated by the statute which provides for incorporation and by the charter, which must be in conformity with the statute. Many details of administrative organization and administrative powers which are not stated by either the statute or the charter must be provided by a set of by-laws. The by-laws guide the officers in the management of the company; and for the sake of completeness they frequently repeat many of the provisions of the statute and the charter.

The laws of most states do not prescribe the provisions that must be contained in the by-laws. The following are among the common provisions:

1. *The location of the principal office and other offices.*

2. *The date and place of the annual meeting of the stockholders.* Provision is also made for serving notice of the meeting, the procedure to be followed at the meeting, and the type of business to be transacted. Similar provisions are made for special meetings.

3. *The number, term of office, qualifications, powers, and compensation of the directors.*

4. *The date and place of meetings of the board of directors, the method of calling directors' meetings, procedure at the meetings, provisions for standing committees of the board, and powers of the board.* There may also be definite restrictions upon the powers of the directors, such as the power to borrow money.

5. *The officers of the corporation, the method of their appointment, term of office, and duties.*

6. *The form of the stock certificates of the corporation, provisions for their transfer, and provisions for the replacement of lost*

certificates. Provisions may be made for the inspection of the stock record books by the stockholders.

7. *Provision for a corporate seal.* Formerly, certain corporate contracts were not legally binding unless they bore the corporate seal. The seal is no longer required to make contracts legal, but most corporations make provision for the adoption of a seal.

8. *The method of amending the by-laws.*

A number of other provisions are sometimes included. The by-laws may require the directors to submit all proposed actions of a certain type to the stockholders for approval. They may fix the salaries of the officers or provide for a profit-sharing plan. In a corporation whose shares are held by a small number of persons, called a close corporation, the by-laws may include an agreement among the shareholders binding them not to sell their stock to outsiders until it has first been offered to the other shareholders. Such an agreement is really not a by-law but a contract between the shareholders.

The power to make the by-laws is vested in the stockholders. By the common law the stockholders have the power to make and amend the by-laws, though they may delegate this power to the board of directors. The reason why this power is vested in the stockholders is that they have very little direct control over the administrative activities of the board of directors or the officers of the corporation, and whatever control they have must be exercised in broad measures or regulation. They set up the administrative organization and then delegate the execution of the policies to the directors and officers. The framing of the by-laws is an essential part of the setting up of the framework of the corporate organization.

III. Doing Business in Other States

The charter may authorize a corporation to do business in any state and in any foreign country, but the incorporating state cannot give the corporation the right to enter other states to do business. The consent of the state in which the corporation wishes to do business must be obtained. No state is required to admit corporations from other states, but the states uniformly do so as a matter of courtesy, this courtesy being known as the *rule of comity.* Corporations doing business in a state other than the one from which

they have their charters are *foreign* corporations; corporations doing business in a foreign country are *alien* corporations.

Each state prescribes the conditions upon which foreign corporations may enter to do business. While all of the states permit foreign corporations to enter to do business, each state is free to regulate them as it pleases; it can exact whatever fees it deems proper, and it can require the rendering of whatever reports it considers desirable for purposes of regulation and for the collection of taxes. These regulations show very great diversity. The majority of states admit foreign corporations on terms similar to those imposed upon domestic corporations. Practically all the states require that some agent be named, in a publicly filed document, on whom service of legal process may be made; the purpose of this requirement being, of course, to protect citizens of the state by enabling them readily to sue the corporation for any wrong or breach of contract committed by the corporation, its agents or servants.

Many states will not permit local registration of foreign corporations whose authorized business is of such nature that it could not be conducted by a domestic corporation. Some states provide that if a foreign corporation wishes to conduct an intrastate public service business, it must incorporate itself under the corporation act of the state. Railroads have often reincorporated voluntarily to facilitate the crossing of state lines.[6]

The usual motive of the legislature in imposing taxes upon foreign corporations is to procure additional revenue for the state, but occasionally the appeal to popular feeling against corporations, and particularly foreign corporations, has been a factor. On the other hand, some states follow a very liberal policy toward foreign corporations, believing that the prosperity of the state is increased by the attraction of outside capital.

A state can require reports and taxes of foreign corporations only if the foreign corporation does an intrastate business in that state. If a corporation does solely an interstate business to and from any state, it does not have to qualify to do business in that state, for no state can impose any requirements which would constitute an interference with the power of the Federal government to regulate interstate commerce.[7]

[6] "Multiple Incorporation as a Form of Railroad Reorganization," *Yale Law Journal*, June, 1937, Vol. 46, pp. 1370-1386.

[7] International Book Company *v.* Pigg, 217 U.S. 91, 109 (1910).

Much confusion exists over the question of what constitutes intrastate business. The character of the business rather than the amount of business done usually determines whether a corporation is doing business within a state. Intrastate business is business of such a character as to warrant an inference that the foreign corporation has subjected itself to local jurisdiction. This is usually construed to mean that the corporation is transacting within the state a substantial part of its ordinary business which is continuous in character as distinguished from occasional transactions. The question is largely one of fact, to be determined by the court after a study of the circumstances in each case. A single act in another state usually does not constitute doing business there.

The difficulty in determining what constitutes doing business within a state may be illustrated by a few examples.[8] The following constitute doing intrastate business: buying timber and shipping it out of the state; conducting branch stores separately organized and doing business as independent business houses; making repairs to buildings or machinery; and installing seats in a theater. The taking of orders by salesmen within the state does not constitute doing intrastate business, regardless of whether or not the salesmen have samples; neither does the shipping of goods into a state in filling orders secured by salesmen there. A corporation may maintain an office within a state without being considered as doing intrastate business, provided the sole purpose of the office is to facilitate the transaction of interstate commerce or to manage the internal affairs of the corporation. However, if samples are sold at the office, or payments are received on account, or a deposit account is maintained at a local bank, the corporation may be held to be doing business within the state. Conducting a mail-order business does not constitute intrastate business. Neither does the purchase of goods in a state through agents of the corporation or through the mails, provided the goods are shipped outside the state in the condition in which they were purchased. Shipping shrubbery or lightning rods into a state is not intrastate commerce unless the vendor fixes the lightning rods to houses or plants the shrubs. The sharing of office space in New York with no ownership of tangible property, maintaining a bank account in the state, and

[8] For discussion of this problem, see H. A. Haring: *Corporations Doing Business in Other States*. Ronald Press, New York, 1927. S. D. Thompson: *Corporations*, Vol. 8. Bobbs-Merrill Co., Indianapolis, 1927. Robert S. Stevens: *Handbook of the Law of Corporations*, pp. 837-847. West Publishing Co., St. Paul, 1936.

making minor investments of funds in New York Stock Exchange securities does not constitute doing an intrastate business in New York.[9] The making of deliveries to customers by a public warehouseman acting as agent of a foreign corporation may or may not constitute doing business, depending upon the state, the authority of the warehouseman, and other seemingly unimportant details. This confused problem shows no promise of being clarified in the near future, and corporations which conduct any business transactions beyond the limits of the original incorporating state must exercise great care. Surprising and costly complications are frequently encountered.

The penalties for failure to comply with the law for foreign corporations vary. A corporation doing business in another state without authorization from that state is usually subject to heavy penalties, but the amount and nature of the penalties vary. One common penalty is the imposition of a fine. In some states the fine is a certain sum for each transaction, while in other states it is a stipulated sum for each day the corporation does business within the state without having complied with the law. In addition to levying a fine upon the corporation, some states make the officers and sometimes the employees of the corporation personally liable to fine. Such fines as are levied upon officers or employees are, however, usually relatively small in amount. A second form of penalty is to make the officers personally liable for the debts of the corporation, and a third is the refusal of the courts to enforce the contracts of the corporation. The latter is the most serious penalty of all, for the corporation is not able to collect its accounts receivable or sums due it on contracts for construction. Many heavy losses have been so incurred.

Foreign corporations are required to make annual reports to the state. The annual reports required of foreign corporations, like the annual reports required of domestic corporations, are intended principally to facilitate the collection of taxes and to make sure that the law is being complied with. The exact information called for in the report varies with the state. The report may include such information as the following:

1. The name of the corporation.

2. The state or foreign country from which the charter was received.

[9] Elsner *v.* United American Utilities, 180 Atl. 589 (Del., 1935).

3. The location of the principal office.

4. Names and addresses of the officers.

5. Name and location of offices and names and addresses of agents of the corporation within the state.

6. Name and address of the officer who is responsible for paying state fees.

7. Date of annual meeting.

8. Nature of business transacted.

9. Value of property owned and used in the state.

10. Amount of business transacted within the state.

11. Property located outside the state.

12. Amount of business transacted outside the state.

13. Fair value of the capital stock on an asset basis.

14. The amount of Federal income tax paid.

The necessity for making the various reports is some inconvenience but not a serious burden. Of much more significance are the taxes levied upon the corporation by the incorporating states and other states. On the other hand, incorporation must be considered a privilege and not a right, and the incorporators receive substantial advantages in return for the requirements made upon them by the state.

IV. The Choice of a State for Incorporation

Many things are considered in choosing the state in which to incorporate. Some of these things have been mentioned in the preceding paragraphs, and others will be touched upon in succeeding chapters, but they may be conveniently summarized here. The most important are as follows:

1. *Taxes and fees.* The greatest difference in fees is in the charge made by the state for the filing of the charter. A study of charters granted by Delaware to businesses located in Wisconsin showed that the average cost was only $360.84, whereas the average cost for these same corporations under the laws of Wisconsin would have been $5,561.32.[10]

[10] John H. Shiels: "Why Do Wisconsin Concerns Leave Home?" *Wisconsin Law Review,* 1936, Vol. 11, pp. 453, 462. The study covered the years 1900 to 1936.

2. *The powers permitted the corporation.*

3. *The number, residence, and qualifications required of the incorporators.*

4. *Duration permitted.*

5. *Reports required.*

6. *The kinds of stock which the state permits the corporation to issue, and their par value; also whether no-par stock may be issued.*

7. *Whether stock may be paid for in services and labor as well as in property.*

8. *The minimum amount of authorized capital permitted, and the amount which must be paid in to begin business.*

9. *The number and the residence requirements of directors.*

10. *Whether meetings of stockholders and directors may be held outside the state.*

11. *The reputation of the state.* This involves principally the reputation for dealing fairly with corporations and the reputation for having a fully developed system of law based upon court decisions interpreting the statutes. It involves also the reputation of the state in regard to the protection of the interests of stockholders and creditors.

12. *Where the business is to be done.* If the business is to be conducted entirely within one state, it may be cheaper to incorporate there instead of incorporating elsewhere and entering as a foreign corporation. If a charter is secured from a state other than the one in which business is to be done, it is necessary to pay incorporation fees in one state and qualifying fees in another.

The laws of most of the states are so liberal that no difficulty may be encountered in regard to most of the requirements. The usual number of incorporators is three or more, their place of residence may be anywhere, and they may hold the first meeting at any place within or without the state of incorporation. The stockholders may reside anywhere and hold their meeting outside the state if the charter so provides. Three or more directors are usually required; and if they must own one share of stock, the requirement is easily met. Aside from the taxes or corporate fees, decision to incorporate in a state may depend upon a few of the provisions of the statute. In the District of Columbia, for example, a majority of

the directors must be citizens of the District. All of the stock must be subscribed and paid before the corporation may begin business. In New York two-thirds of the incorporators must be citizens of the United States and one must be of legal age. One director must be a citizen of the United States and a resident of New York. The principal office must be in New York, and the stock book and books of account must be kept at the principal office. Provisions of this kind are likely to be controlling if a business in one state is considering incorporation in another.

Incorporation has also been made easy because of the services of incorporating agencies. Corporate agencies (the best of them acting only for lawyers in facilitating their work) perform all the work necessary to procure the charter, including applying for the charter, paying the fees, supplying the dummy incorporators, holding the first meetings of stockholders and directors, acting as resident agent of the corporation, maintaining the local office, and displaying the corporate sign. The result is that incorporation in a distant state where the fees are small and the corporation laws are lax, has become both cheap and easy.[11]

Uniformity of incorporating requirements is needed. The competition of the various states and the increasing laxity in the corporations laws have created a serious need for uniformity in the incorporation laws. This need might be satisfied in any one of several ways.

1. *A uniform business-corporation act, enacted separately by each state.* A number of uniform laws have been drawn up and many of them have been enacted by a large number of the states. Among such laws, besides the uniform business-corporation act, are the uniform partnership act, the uniform negotiable-instruments act, and the uniform stock-transfer act. The uniform acts which have thus far met with success, however, do not affect the revenues of the states as vitally as would the enactment of the uniform corporation act.

As early as 1909 the subject of a uniform business-corporation act was discussed before the National Conference of Commissioners on Uniform State Laws. In 1928 a uniform business-corporation act

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[11] For further discussion of the competition among the states in granting of corporate charters, see W. Z. Ripley: *Main Street and Wall Street*, pp. 24-37. Little, Brown, and Co., Boston, 1927. H. R. Seager and C. A. Gulick: *Trust and Corporation Problems*, pp. 42-48. Harper and Brothers, New York, 1929. Also R. C. Larcom: *The Delaware Corporation*. The Johns Hopkins Press, Baltimore, 1937.

was approved and recommended for adoption by the several state legislatures. It was realized that since the policy of states toward corporations differed in different sections of the country, complete uniformity would not be possible; and the conference therefore indicated that many provisions were meant to be optional and that the states were expected to adapt certain sections of the act to suit local conditions. The principal object of the proposed act is to secure uniformity, not in the matter of taxes and fees, but on certain legal questions about which the laws of the various states and the decisions of the courts differ. Among such questions are *ultra vires* acts, *de facto* corporations, the liability of subscribers for their shares, the liability for dividends wrongfully paid out of capital, the relation of directors to the corporation, and the like. Although the uniform incorporation act has been adopted practically without change in a few states, and has been used as a model in others,[12] it is too much to hope that the competition of the states in attracting corporations will be stopped by the uniform corporation act even if its essential features should be generally adopted.

2. *A system of licensing by the Federal government.* If the Federal government were to require that any corporation engaging in interstate commerce must obtain a Federal license, it could make the granting of such a license conditional upon the meeting of certain requirements. The states would issue the charter with a measure of Federal regulation. Since most corporations, and particularly those in which there is serious need for more effective regulation, are engaged in interstate commerce, this might be a satisfactory method of securing uniformity. The system of licensing might be used in conjunction with the uniform incorporation act, a license being granted only to corporations complying with the act.

3. *Permissive Federal incorporation.* It has been advocated that the Federal government along with the state governments might issue charters to corporations engaging in interstate commerce. A corporation thus would have its choice of securing a charter from either the Federal government or one of the states. The objection to this plan, aside from that of its doubtful legality, is that corporations wishing to exercise broad powers with little supervision could still obtain charters drawn up to suit their own wishes from

[12] Robert S. Stevens: "Uniform Corporation Laws through Interstate Compacts," *Michigan Law Review*, June, 1936, Vol. 34, pp. 1063-1092.

certain of the states. The result would be largely that another incorporating agency would be added to the 49 already existing in the United States.

4. *Compulsory Federal incorporation.* This seems to be the only effective plan. One objection to it is that it would be vigorously opposed by the states, which would lose a substantial amount of revenue; and while this is not a vital objection—since all taxes come from the people and since the states could find some other source of income—it is so important that it is likely to cause the defeat of any plan put forward. A second objection to a plan of compulsory Federal incorporation is that it is of doubtful constitutionality; many constitutional lawyers contend that it is constitutional, but people who object to the proposal on other grounds can use the argument of unconstitutionality to advantage. A third objection is that it adds another power to the Federal government. The complaint of increasing bureaucracy and growing centralization of power in the Federal government is often repeated. Although the proposal of Federal incorporation has much to recommend it, the plan is not near adoption.[13]

Questions

1. How can the corporate charter be considered a contract when the corporation does not exist until the charter has been granted?

2. What difference does it make whether the charter is a contract or not? What could the charter be if it were not a contract?

3. Who are the parties to the contract which brings the corporation into existence?

4. For what reasons may a state modify a charter after it has been issued? On what grounds may Congress modify charters?

5. Distinguish a *de facto* corporation from a *de jure* corporation. Does it make any difference that a corporation is *de facto?*

6. What is necessary to the recognition of a *de facto* corporation?

7. What should be included in a corporate charter?

8. What are the legal requirements as to the name of the corporation?

9. Who is responsible for seeing that the name of a company does not infringe upon the rights of another?

10. W. C. Childs acquires a controlling interest in the Fairfax Textile

[13] For a compilation of proposals for Federal licensing and Federal incorporation, including discussion of the plans, see Federal Trade Commission, *Utility Corporations,* Part 69A (1934). Also Harris Berlack: "Federal Incorporation and Securities Regulation," *Harvard Law Review,* Jan., 1936, Vol. 49, pp. 396-425.

Corporation, a small manufacturing company. He wishes his own name to be a part of the name of the corporation. What should he do to change the name of the company? How could he retain the goodwill and the business connections of the corporation under a new name?

11. Why is it necessary for the corporation to maintain an office in the state which issued the charter?

12. Why did the law formerly permit a corporation to conduct only one kind of business?

13. What is the doctrine of implied powers? How do the implied powers of the corporation resemble the implied powers of the Federal government?

14. What powers would be necessary and proper to the operation of a laundry?

15. How can the dangers incident to perpetual charters be avoided?

16. Who should draw up the by-laws? What is included in them?

17. What is the rule of comity?

18. Compare the single proprietorship, the partnership, the business trust, and the corporation from the point of view of their right to enter various states to do business.

19. When is a corporation usually considered to be doing business in another state?

20. What are the penalties for failure to qualify to do business in a state?

21. Are uniform incorporating requirements desirable? What four ways of obtaining uniformity have been suggested?

22. What should be taken into account in the selection of a state for incorporation? What are usually the determining factors?

CHAPTER IX

Capital Stock and the Stockholders

The control of the affairs of the corporation lies in three groups of persons—the stockholders, the directors and the officers. Each group has authority over certain phases of policy formation and management. The stockholders, in theory if not in fact, determine the broad policies of the corporation, entrusting the supervision of corporate affairs to the directors and the detailed management to the officers. In the present chapter the relations of the stockholders to their corporation and also the rights and powers inherent in the various classes of stock are to be considered.

I. The Nature and Kinds of Stock

All stock of a corporation is alike unless the charter gives some classes of stock special privileges, such as voting or dividend rights, or denies the usual privileges to some classes. We shall therefore consider, first, the nature of stocks as a group, and second, the classification of stocks from the point of view of their rights and privileges.

A share of stock represents a fractional ownership in the corporation. The stockholders do not hold title to the property, for title is vested in the corporation. But since stockholders as a group own the corporation, a share of stock represents a pro rata interest in the assets. If there are 1,000 shares of stock outstanding, each share represents an ownership of 1/1,000 of the corporation. The value of stock therefore depends upon the value of the assets of the corporation and their earning power.

There are many kinds of stocks. While all stocks represent ownership, the rights of ownership are not always the same for all shares. State laws permit the incorporators to provide for more than one class of stock, and such provision is very often made. The following classification includes the usual groups of stock.

If preferred stock is non-cumulative, a dividend which is not paid in any one year is lost to the shareholder; and if in subsequent years the corporation pays dividends, the holder of non-cumulative preferred stock is entitled to the dividend for that year only.

In order to protect the interests of the holders of non-cumulative preferred stock, the corporate charter sometimes requires the directors to pay the non-cumulative preferred dividend when the corporation has had sufficient earnings to enable it to do so. In other cases, however, the corporate charter declares that the shareholder is entitled to dividends only if, as, and when declared by the board of directors.[1]

If the preferred stock is participating, it is first entitled to a specified dividend, and after the common stock has received a dividend which might be a like amount or any percentage stated in the corporate charter, it participates with the common stock in any further dividend distributions. If the preferred stock is non-participating, it is entitled to the preferred dividend and no more, all further dividend disbursements going to the common stockholders. Most preferred stocks are cumulative but non-participating.

The laws of some states permit many other variations in the dividend rights of different groups of stocks. For example, the preferred stock may receive a fixed initial dividend; and after an initial dividend on the common stock, the preferred may participate with the common up to a limited amount, all of the remaining profits going to the common. The preferred stock may even receive all of the profits after the fixed initial dividend on the preferred and a fixed initial dividend on the common. After a fixed initial dividend is paid on the preferred and common stock, the remaining profits may be shared in any number of ways by two or more issues of preferred or common stock.[2]

Many corporations have more than one kind of preferred stock. Thus, a corporation might issue 5 per cent first preferred, 6 per cent second preferred, and 7 per cent third preferred. The different classes of preferred stock may have preferences as to each other both as to assets and as to dividends. No stock, either common or preferred, is entitled to dividends unless, first, the corpora-

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[1] W. H. S. Stevens: "The Discretion of Directors in the Distribution of Non-Cumulative Preferred Dividends," *Georgetown Law Journal,* Jan., 1936, Vol. 24, pp. 371-396.

[2] W. H. S. Stevens: "Stockholders' Participation in the Profits," *The Journal of Business,* April, 1936, and July, 1936, Vol. 9, pp. 114-132, 210-230.

tion has surplus earnings out of which dividends may be paid and, second, the directors authorize their payment.

Preferred stock classified as to voting rights. Most preferred stock carries no right to vote. The argument in favor of non-voting preferred stock is that if the dividends are protected by ample earnings, the stock has an investment standing and the preferred stockholder is in much the same position as the bondholder, who usually has no voting rights. Moreover, it is argued, the small stockholder does not care to vote, and it does not strengthen the corporation to have a great number of stocks outstanding which have voting rights that are never used. There are real dangers, however, in having several groups of security holders supply the capital while only one and sometimes a small group of stockholders has voting rights.

Besides voting stock and non-voting stock, there is another class of preferred stock called *contingent voting stock.* Contingent voting stock is that stock which ordinarily does not vote but which does get the right to vote upon the occurrence of certain contingencies. The more common contingencies are as follows: (1) The failure of the corporation to pay dividends. The period for which dividends must go unpaid before preferred stock gets the right to vote varies from three months for some corporations to several years for others. (2) Failure to maintain the corporation in strong financial condition. This must be judged by certain definite standards, such as a certain ratio of current assets to current liabilities or of fixed assets to the par value of the preferred stock outstanding. (3) Failure of the earnings to reach a certain level.

Limited-voting preferred stock is stock that has the right to vote only on certain propositions which vitally affect the position of that class of stock. For example, the preferred stock may be permitted to vote upon a proposal to sell important units of the property of the corporation, to mortgage the property, or to issue stock or bonds having a claim prior to that of the preferred stock.

Preferred stock classified as to par or no par value. Par value is an arbitrary value assigned to either preferred or common stock for accounting purposes. The stock is shown in the accounting records and in the financial statements at par value, the difference between par value and the amount received for the stock being shown as stock discount or stock premium. The par value has a legal significance also. In most states it represents the minimum amount for which stock can be sold without liability to the purchaser. If a share is sold for less than par value, the purchaser is

liable for the discount, in the event of the insolvency of the corporation. In other words, the liability of the purchaser does not arise unless the corporation becomes insolvent, and if it does he may be required to pay the corporation the amount of the discount which is the difference between par value and the price he paid for it. This payment would be made to the corporation but for the benefit of creditors.

Until 1912 when New York state authorized the issuance of no par stock, all stock had a par value. Usually the par is $100, but it may be more or less than that amount. Many shares have a par value of $10, $25, or $50, while some have a par value of as much as $1,000. If no par stock is preferred as to assets, the amount of the preference must be stated in dollars, and the stock becomes much like stock with a par value. However, there is no stock discount for which the purchaser might be liable in case of the failure of the corporation. The accounting is simplified, also, since the corporation need not show a par value or a discount or premium on stock in its accounts and reports.

Convertible preferred stock. Preferred stock is sometimes convertible into common stock. The dates at which it may be converted and the terms of conversion are stated in the charter. Usually conversion must be made at the dividend dates. The rate of conversion may be $100 of preferred for each $100 share of common; or it may be some other rate, such as $1,200 of preferred for $1,000 of common. Conversion is usually at the option of the shareholder, but it may be at the option of the corporation. Preferred stock is seldom made convertible into bonds, but bonds may be convertible into preferred stock or common stock. Conversion is the right to exchange a security having a prior claim upon earnings or dividends, called a senior security, for a security having a later claim, called a junior security.

Redeemable preferred stock. Sometimes preferred stock may be redeemed or called for payment in cash. If the stock is called, the stockholder is paid a specified sum, and the stock is retired. The price at which the stock is called is stated in the charter, but the redemption price is always more than the issue price. Usually the stock cannot be redeemed until a number of years after the date of organization of the corporation or the date of issue of the stock. Redemption is at the option of the corporation and not of the stockholder. The usual reason for the redemption of preferred stock is to reduce preferred dividends which may be at a relatively high rate.

Common stock usually has the right to vote. In every business corporation there must be some stock with voting rights; otherwise there would be no way of electing directors and accomplishing other things that stockholders do at their annual and special meetings. If some common stock does not have the right to vote, provision is made for two or more kinds of common stock, one kind being voting and the others nonvoting. Nonvoting stock is frowned upon by the stock exchanges, although it has been used by a number of well-known corporations.

The argument for nonvoting common stock, like the argument for nonvoting preferred stock, is that the small stockholder does not care whether or not he has the right to vote. If some stockholders do not care for the right and would not exercise it if they had it, it is argued that nonvoting stocks may be issued to them and voting stocks held by the large stockholders who will attend stockholders' meetings. This usually means that the promoters or original incorporators keep the voting stock and sell nonvoting stocks to the public. To place the management in a position in which it may permanently maintain itself in control may prove to be very bad for the corporation and for the holder of the nonvoting stock. The right of the stockholder to vote if he cares to do so and if he sees that a need for a change in the management has arisen, may prove to be a very valuable check upon the management.

Common stock may or may not have a par value. If common stock has a par value, it may be anywhere from a fraction of a cent to $1,000 or even more. For example, the William Henry Products Co. of Washington, D.C., was incorporated under the laws of Maryland with an authorized capital of $1,000 divided into 1,000,000 shares with a par value of one mill each. On the other hand, both the par value and the issuing price of stock have sometimes been set very high in order to discourage speculation in it. The par value is usually fixed at an amount somewhere between $10 and $100.

The par value of capital stock, whether preferred or common, has a significance for creditors and perhaps also for future stockholders. It may indicate to them the minimum amount which the original purchasers of the stock committed to the enterprise as its permanent capital. Thus, an outstanding issue of $500,000 par value stock may be interpreted to mean that the original purchasers paid at least that amount into the corporation in cash, property, or services at a fair valuation. If the purchasers of the stock paid less

than that sum or if the property or services were overvalued, prospective security holders, whether of stock or bonds, are misled and may require that the difference be paid into the corporation. That is to say, the purchasers of the stock may be liable for the discount.

Par value is also significant in that it indicates the minimum permanent capital which cannot be withdrawn for the payment of dividends. Although the capital paid in by stockholders may be impaired by losses, it is some protection to creditors to know that it cannot be used for dividends. Whether sums paid for stock in excess of par value may be used for dividends depends upon the state, but the tendency is to permit dividends to be paid only from profits or net income.

The principal argument for no par value stock is that it is more in conformity with the real nature of corporate stock. Although stock represents only a fractional interest in the assets and earnings, the par value may be interpreted by investors to mean that the corporation has assets back of the stock at all times equal to the par value and that any stock which sells for less than par is a bargain. Another argument against par value stock is that it may result in an overvaluation of assets since the directors will be inclined to value property received in exchange for stock at the par value of the stock regardless of the value of the property. The assignment of a par value to stock may also require financing methods which are contrary to the best interests of the corporation. If as a result of operating losses or a discouraging prospect for dividends the stock declines in the market to less than par, the new issue of stock cannot be sold for par but if sold at all would have to be issued at a discount. Prospective investors would hesitate to buy stock at a discount because of a possible liability in the future. They would buy the old stock in the market rather than buy the new issue from the corporation. The result would be that the corporation would be compelled to resort to bank loans or bond issues for the new money required in the business, whereas prudent financing might indicate that stock should be issued.

The use of no par stock has given rise to a number of new problems. It is found to permit of an easy manipulation of financial statements because a part of the amount paid in by stockholders may be shown as paid-in surplus. The paid-in surplus may be set up at the time the stock is sold or at a later date by vote of the directors. In the absence of Federal regulation, such amounts might be shown merely as surplus without any indication whether

the funds were paid in by stockholders or resulted from earnings. Properties paid to the corporation in exchange for stock may also be overvalued on the books even though no par stock is issued in exchange for them. The issuance of stock without par value also decreases the liability of officers and directors for overvaluation of assets since there is no discount for which they are liable. From the point of view of the corporation, no par value stock may be undesirable because it increases the state franchise tax. For tax purposes, no par stock is usually assumed to have a par value of $100, which may be in excess of the amount for which it is sold. Many corporations which originally issued no par stock have amended their charters to provide for par value. In such cases, the old stock is retired and new certificates are issued to stockholders.[3]

II. The Rights of Stockholders

The rights of stockholders may be classified as *group rights* and *individual rights.* The group rights are those rights which the stockholders have when assembled at their regular and special meetings, while the individual rights are the rights which each stockholder has as an individual and without reference to any other stockholders. The individual rights relate principally to the protection of property and voting rights in the corporation. Each type of right is embodied in common and statutory law and is often reaffirmed in the charter.

Stockholders as a group have important rights. The stockholders constitute an essential part of the working mechanism of the corporation, for they are empowered to formulate the broad phases of corporate policy. They are the legal owners of the corporation; and although they entrust the actual management to others, they retain the right to decide certain general questions relating to the affairs of their company. Specifically, the stockholders have the following rights:

1. To adopt and amend the by-laws.
2. To elect the directors.

[3] For discussion of no par value of stock, see W. Z. Ripley: *Main Street and Wall Street,* pp. 46-54; Little, Brown and Co., Boston, 1927. I. Maurice Wormser: *Frankenstein Incorporated,* pp. 153-156; McGraw-Hill Book Co., New York, 1931. Hastings Lyon: *Corporations and their Financing,* pp. 133-176; D. C. Heath and Co., New York, 1938.

3. To amend the charter, with the consent of the state.
4. To sell the entire assets of the corporation.
5. To dissolve the corporation.
6. To exercise any other powers prescribed in the charter.

The percentage of the stock necessary to adopt a proposal depends upon its nature. The sale of the assets of the corporation formerly required the unanimous consent of the stockholders. However, it was found that this provision placed a minority or even a single shareholder in a position to blackmail the corporation, and the tendency in recent years is to require no more than a two-thirds majority. In some states a majority is sufficient if the corporation is in danger of financial failure. A majority vote is sufficient to remove directors from office prior to the expiration of their term, to authorize the mortgaging of the assets, or to approve the consolidation of the corporation with another.

The incorporators, acting for the stockholders, set up a working organization for the corporation. The first meeting of the stockholders is attended by the incorporators only, since other subscribers to stock have not been recognized. The meeting is called by one of the incorporators after the charter has been granted. The usual order of business is as follows:

1. *The election of a chairman and a secretary.*

2. *The acceptance of the certificate of incorporation.*

3. *The adoption of the by-laws.* These have usually been prepared and agreed upon by the promoter and financiers in advance, and their adoption at the first meeting is only a matter of form. If the by-laws have not already been prepared, a committee is appointed and recess is taken to enable the committee to draw them up.

4. *The election of the first board of directors.* The incorporators have the right to one vote for each share of stock owned, and the meeting is itself the judge of the qualifications of the voters. In some states the first board of directors is named in the charter.

5. *The exchange of stock for property.* Most corporations are formed to take over the business of a partnership or some other corporation. In such cases, the stock is paid for in property, and this exchange is usually ratified by the stockholders. This business is, however, sometimes left for the board of directors to transact.

6. *The transaction of other business as required by statute or by the circumstances of the particular corporation.*

The first meeting is usually a mere matter of form, all questions having been agreed upon in advance; indeed, the minutes of the first meeting are sometimes drawn up by the lawyers before the incorporators assemble. At the meeting the minutes are read, a resolution is passed declaring the minutes to represent the action of the stockholders, and adjournment is taken. Sometimes the minutes are drawn up but the formality of making the motions mentioned in the minutes is carried out. Each person complies with the minutes by making or seconding the various motions as the minutes said he would do. In such cases the minutes constitute the order of procedure as well as the record of what was done.

The stockholders exercise general powers of supervision and policy determination through their annual meetings. The stockholders are entitled to notice of annual meetings, and they may vote either in person or by proxy. The president of the corporation is the presiding officer. The usual procedure at the annual meeting is as follows:

1. Meeting is called to order by the president.

2. The roll is called. In large corporations the persons present are asked to report to the secretary for confirmation of their right to be present and to vote either for themselves or for someone else by proxy. If a quorum of the stock is present, the secretary so reports to the chairman.

3. The secretary presents his proof that notice has been sent to the stockholders as required by law. This may be a certificate to that effect, together with copies of newspapers in which the notice of the meeting appeared.

4. The minutes of the last meeting are read and approved or corrected.

5. Annual reports of the president, the treasurer, and any other officers or committees are read. The president often gives a detailed statement of the business during the preceding year, mentioning any developments which affected the business of the company favorably or unfavorably and discussing the prospects for the company.

6. Directors are elected.

7. Other business, such as voting increases in capital stock or amendments to the charter, is disposed of.

The annual meeting, like the first meeting, is often a matter of form, everything being determined in advance. Sometimes, however, there is a contest for directorships, or even an attempt to secure a complete change of management. In such cases real interest surrounds the proceedings, and sometimes the control is in doubt until the meeting assembles. Any stockholder may comment on the reports of the officers, and even in the meetings of large corporations small stockholders sometimes do so. The important questions, such as the election of directors, are usually decided in advance and merely confirmed at the meeting. Special meetings of the stockholders may be held, but they are inconvenient, and large corporations usually manage to transact the business of the company without them.

The stockholders have important rights as individuals. It was pointed out in connection with the discussion of the kinds of stock that the stockholders may be given priority one over another and that often the rights of some stockholders are arbitrarily restricted by statutory and charter provision. In the absence of such restrictions, the following rights of stockholders as individuals are well established:

1. The right to a share in the dividends if and when dividends are declared by the board of directors.
2. The right to a share in the assets of the corporation in case of dissolution.
3. The right to be notified of stockholders' meetings and to vote at such meetings in person or by proxy.
4. The right to inspect the records of the corporation.
5. The right to participate in additional issues of stock.
6. The right to sell their stock.
7. The right to receive a stock certificate.

The first two of these rights have already been sufficiently explained in the preceding paragraphs. The last five require further consideration.

The right to vote is inherent in the nature of the stock. Since stockholders are the owners of the corporation, it follows that they should be permitted to have some voice in its management. This

includes the right to appear at the regular and special meetings of the stockholders and to vote. If a stockholder is unable to attend the meeting in person, he may authorize someone else to vote in his place. The person who is authorized to vote in place of another is called a proxy, though the authorization itself is frequently called a proxy. It is not necessary to own stock in order to act as a proxy. Stockholders' meetings usually may be held either within or without the state which grants the charter. Provision for the place of meeting is sometimes made in the charter, though more often such provision is found in the by-laws.

The exercise of the right to vote has been greatly affected by the wide diffusion of ownership of stock. In recent years the stocks of many corporations have become very widely diffused, and many corporations now number their stockholders in the tens of thousands, even hundreds of thousands. American Telephone and Telegraph Company with more than 680,000 has the largest number, but General Motors Corporation has 422,000, United States Steel Corporation has 238,000, General Electric Company 229,000, and General Foods 68,000. These are typical of our large companies.

As a result of the diffusion of stock ownership, there are a great many stockholders who do not attend stockholders' meetings. Frequently a single stockholder conducts the annual meetings by himself. He may preside, make the motions, vote the stock for the motions which he makes, and elect the entire slate of directors. To be sure, he follows instructions which he has received from the officers and directors of the corporation in all that he does. An attendance of 75 stockholders at an annual meeting would represent an unusually large attendance, while the average is much less than that figure.

There are several reasons for the failure of stockholders to take an active interest in the affairs of their corporations: (1) In many cases the stockholder knows nothing about the business. The list of stockholders of any large corporation includes persons in all ranks of life, many of whom could not be expected to be expert either in the business of the corporation or in financial management. And it may be just as well that many stockholders do not attempt to exercise any supervision over the affairs of the corporation. (2) The stockholders could not exercise an active interest in the affairs of the company if they chose to do so, since the number of shareholders of many corporations is so large that a meeting place for them would be impossible. (3) Many stockholders cannot assume

responsibility for management because they have too many other interests. (4) The value of the stock investment of many shareholders is not large enough to justify their taking the time and incurring the expense of attending the annual meeting. (5) The attitude of the stockholder towards participation in corporate affairs is in many cases influenced by the fact that he has not held his stock for many years. He often feels himself to be an outsider as compared with the officers and directors who have been associated with the company for many years and have staked their future upon its continued prosperity. For example, in 1925 only ten per cent of the stockholders of the American Telephone and Telegraph Company had owned their stock for as long as ten years. By 1945, the percentage had increased to slightly more than fifty, but it still is true that many stockholders are newcomers in the organization.

In most corporations there are a few persons who assume the responsibilities of active stockholders. It is not necessary that a large percentage of the stockholders attend corporate meetings provided some few large stockholders assume this duty. In some cases it is not clear that any group feels responsible for attendance at meetings. The largest stockholders are frequently investment companies, endowed institutions, universities, insurance companies, brokerage houses, banks, and other corporations not especially interested in management. Fortunately for other stockholders and for the functioning of the economic system, there are many corporations which do have a small group of persons holding in the aggregate as much as fifteen or twenty per cent of the outstanding stock, and these persons can be relied upon to make their influence felt if the situation requires it.[4] But as years pass and these stockholders die, the administration of their estates and the sale of stock through the exchanges will add to the number of corporations for whose management no one group of stockholders can assume responsibility.

The management, by means of proxy voting, is often able to maintain itself in control. Once the management gets into control, it is usually able to make itself permanently secure in its position. Each year before the annual meeting the secretary of the corporation sends out the notices, together with a form called a proxy,

[4] Statistical data of stock ownership may be found in T.N.E.C. Monograph 29: *The Distribution of Ownership in the 200 Largest Nonfinancial Corporations.* Washington, 1941. For a penetrating analysis, see R. A. Gordon: *Leadership in the Large Corporation,* Chapter II. Brookings Institution, Washington, 1945.

which is to be filled out and returned by the stockholder and which names the persons who are to vote his stock at the meeting. The printed form, which the stockholder is asked to sign, names certain of the officers and directors as his representatives. The form of the proxy is illustrated on page 148. Since the expense of mailing the notices and of the postage for their return is paid out of the corporate treasury, it is obvious that the management has a great advantage over anyone who would try to turn them out. As long as the stockholder receives his dividends and has no reason to suspect the dishonesty of the management, he signs and returns the proxy; if he is dissatisfied, his only recourse in most cases is to abstain from voting. If he goes to the trouble and expense of attending the meeting of the stockholders, he will probably find that a representative of the management appears at the meeting with sufficient proxies from the other stockholders to control the elections, and that nothing that he can say or do will influence the results.

The soliciting of proxies is now subject to the regulations of the Securities and Exchange Commission. The soliciting of proxies by managements of companies whose shares are listed on a registered stock exchange and also of all public utility holding companies and all investment companies must be done in accordance with rules and regulations prescribed by the Securities and Exchange Commission. The management cannot solicit proxies for a meeting at which directors are to be elected unless it furnishes stockholders with an annual report including financial statements of the company. In addition, the request for proxies must be accompanied by a proxy statement which includes such material as the following:

The names of directors, their principal occupation or employment, the date when each first became a director, and the number of shares of stock or other securities owned by each.

The remuneration of officers and directors and of all other persons receiving more than $20,000 per year, such as auditors, attorneys, detective agencies, and banks.

The amounts set aside for directors and officers for retirement under any annuity or pension plan.

Discussion of any proposals to be brought before the meeting of the stockholders.

The management must give stockholders a chance to vote for or against any proposal to be submitted for a vote at the meeting. If

THE WASHINGTON CORPORATION—PROXY—194__

KNOW ALL MEN BY THESE PRESENTS, that the undersigned stockholder of the Washington Corporation appoints Frank Knight, John Martin, and L. E. Hastings, and each of them, his true and lawful attorneys and proxies, with full power of substitution, for and in his name, place and stead, to vote at the Annual Meeting and Election of and by the Stockholders of the WASHINGTON CORPORATION in the office of the Corporation, Wilmington, Delaware, on Friday, March 25, 194—, at 11 o'clock A.M., and any adjournment thereof, as fully and with like effect as the undersigned might or could do, if personally present and voting thereat: (1) For Directors. (2) For ☐ or against ☐ the selection of Riggs and Rose as independent public accountants. (3) For ☐ or against ☐ the adoption of resolutions set forth in the Proxy Statement respecting the qualifications of officers and directors. (If the undersigned fails to indicate his vote by a mark ☒ in the appropriate space, the undersigned authorizes said attorneys or substitutes, or any of them, to vote for said accountants and for said resolutions.) (4) On any other subjects that may properly be presented to or at the meetings.

A majority of such attorneys, proxies or substitutes as shall be present and shall act at said meeting or at any adjournment or adjournments thereof (or if only one shall be present and act, then that one) may exercise all the powers of all said attorneys and proxies hereunder.

WITNESS the hand and seal of the undersigned this...........

day of.........................., 194__

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Signature of Stockholder

FORM OF PROXY

minority stockholders wish to submit a proposal, the management must include a discussion of it in the proxy statement. For the protection of the corporation, it is required that any group of stockholders wishing to present a proposal to the meeting must give the management adequate notice of its intentions. As a further protection to the management, the officers are permitted to solicit proxies before the annual report is prepared if they learn that an opposition group is soliciting them. In any case an annual report must be furnished stockholders twenty days before the meeting. If proxies are improperly solicited, the Commission may require the adjournment of the meeting and the resolicitation of proxies.

The right to vote the stock of a corporation may be assigned for a period of years by means of the voting trust. Sometimes the stockholders as a body may assign to trustees the right to vote their stock for a designated number of years. The trustees to whom the stock is assigned are entered upon the books of the corporation as owners of the stock entitled to vote, and the stockholders who assign the stock receive trust certificates which are designated as certificates of beneficial interest. By means of this device, which is known as a *voting trust,* the stockholder assigns his right to vote while retaining his interest in the assets and in the earnings of the corporation. When the period of the trust expires, the trust certificate is surrendered and the stock is returned to the owner.

When voting trusts were first introduced, the courts were hostile to them, and some courts declared such agreements void because they were against public policy. It was held to be dangerous to the public interest for the holders of stock to transfer their rights to vote to another person for a period of years. This opposition has gradually diminished, and voting trusts are now held to be legal if made in good faith for the benefit of the corporation.[5] They have been frequently used in the reorganization of railroads. Among the roads whose stocks have been controlled by means of voting trusts are the Erie, the Southern, the Baltimore and Ohio, the Chesapeake and Ohio, the Seaboard, the Northern Pacific, and the Chicago, Milwaukee, St. Paul and Pacific.

The evils which may result from unchecked management control are many. In the absence of a check from stockholders, the management may increase its own salaries or other compensation. Those officers who are also directors may propose and vote increases

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[5] For statement of the legality of the voting trust, see Alderman *v.* Alderman, 181 S.E. 897 (S. Car., 1935).

for each other, or they may approve bonus-sharing plans in which all participate. The management may also award contracts for construction, advertising, or purchase of materials to other corporations in which they are interested. For personal prestige, the management may carry out unwise business expansion. It may also refuse to wind up an enterprise even though it shows no prospect of profit. Dividends may be denied to stockholders in order that the funds may be used for other purposes desired by the management.

Much has been done to protect the interests of stockholders. The legislation designed to protect the interests of stockholders includes the requirement of full disclosure to stockholders when proxies are solicited and also when securities are sold in interstate commerce or listed for trading on a stock exchange. Several types of companies including railroads, public utilities, and investment companies have been brought under close supervision and control. Managements have themselves sought in many ways to protect the interests of their stockholders. Some have sought to keep stockholders informed by conducting conferences with them in various cities. On the whole, such conferences have not been very effective, however, since either the questions asked by stockholders at the meetings are concerned with information which would be of value to competitors if it were to be disclosed or the questions are trivial in nature.

The stockholder has the right to inspect the stock records. By the common law every stockholder has the right to inspect the corporate books and records to obtain information as to the affairs of the corporation. This is usually interpreted to mean that the stockholder has the right to inspect the stock records showing the names and addresses of stockholders and the number of shares owned by each. Even the right to inspect the stock records is subject to limitations and the stockholder may be required to show in court that the examination is germane to his interest as a stockholder. Moreover, the right must be exercised at reasonable and proper times, and the examination must take into consideration the convenience of the officers of the corporation.

As corporations have increased in size and in number of stockholders, the right to inspect the stock records has been further restricted by statute. In New York the right is limited to persons who have been stockholders for at least six months, or to persons holding stock equal to five per cent of the outstanding shares. If a

stockholder can show that he has good cause to inspect the stock records, he may be granted a court order to do so even though he cannot meet either of the other two requirements. In California the directors may by unanimous vote deny to a stockholder the right to inspect the books if they believe that he intends to use the information to the detriment of the corporation. In some states a shareholder must hold a stated percentage of the stock for a specified period prior to the date of the demand.

In a few states the stockholders have been given by statute the right to financial statements of the corporation. A few states require that the directors cause financial statements to be sent to each stockholder after the close of the fiscal year unless such reports be dispensed with in the charter or by-laws. A few states provide that if a specified percentage of the stockholders petition the directors for financial statements, the statements must be supplied to them. Such laws are the exception rather than the rule.

The stockholder usually has the right to subscribe to additional stock to be sold. If the corporation wishes to sell any stock, it must first offer it to its stockholders. If the stockholders do not subscribe to the stock, it may then be offered to outsiders but not upon terms more favorable than it was offered to the old shareholders. The right of the shareholder to subscribe to additional issues of stock originated a century ago, and it is fundamental to the protection of his interests. The reason for this is twofold. First, it is necessary to the preservation of the proportional interest or share in the control of the corporation. If the directors were permitted to sell stock freely to outsiders, they would be able to change the control of the company at will. Second, the right is necessary to preserve the equity of the stockholder in the surplus of the corporation. All stockholders have a pro rata interest in the surplus, and the proportionate share of each stockholder depends upon the number of shares outstanding: obviously, then, the sale of additional stock reduces the amount of surplus behind each share, unless the new stock is sold at a price which creates a paid-in surplus equivalent to that which was behind each share of the original stock. The effect is reflected in the decline of the market price of the stock. But stockholders whose equities in the corporation are not affected by the additional issue do not have the right to participate in it; this applies, for example, to non-voting and non-participating preferred stock. The right to subscribe to additional issues of stock is called the preëmptive right.

The right to subscribe to additional stock is subject to certain exceptions. In some cases it has been held that the right does not apply to stock which has been authorized but not issued, but that it applies only to stock issued by amendment to the certificate of incorporation. The argument for such a limitation is that corporations which are in process of formation may find it advantageous to put their stock upon the market in small amounts from time to time. Another exception is that stock which has been sold and then is purchased by or donated to the corporation may be resold without its being offered first to the stockholders. This stock, which is called *treasury stock* or *reacquired stock,* can be sold at any price —or it may even be given away as a bonus with other stock or with bonds.

A further exception is that in some states the directors may issue stock for property. It is by this method that many mergers and consolidations are effected. The reason given for making this encroachment upon the right of the stockholder is that the stockholder has the advantage of an increase in the property of the corporation which compensates him for the increase in the amount of stock outstanding; and this same reason applies with just as much force to an issue of stock for cash. The issue of stock for property, in fact, opens the door to the possibility of serious fraud and resulting losses to the stockholder. In some cases stockholders themselves approve a restriction upon their right to subscribe to new issues of stock in that they agree to the sale of stock to the employees of the company. The number of shares which can be disposed of in this way is fixed by the resolution which the stockholders adopt, but the exact price at which it will be sold is left to the judgment of the directors. This is necessary because of fluctuations in the market price of the stock.

The preëmptive right has been encroached upon still further by amendments to the incorporating acts in a number of states, these acts permitting a charter provision that no shareholder has a right to participate in additional issues. A number of charters now contain a provision which permits directors to sell the stock of the corporation to any person and at any price they choose to ask.

The principal reason for the impairment of the preëmptive right is the increasingly complex financial structure of present-day corporations. The doctrine of the preëmptive right is entirely sound in a corporation which has only one kind of stock. However, if there are several kinds of stock and one class has no right to vote,

the rights of non-voting stock are not affected by the issue of more shares of voting stock. Likewise the right of preferred shareholders to dividends is not impaired by the sale of additional common stock unless the preferred stock is participating. While the holders of contingent or limited voting preferred stock or of participating preferred stock may in some cases be adversely affected by new issues of common stock, the management may be hampered in its legitimate raising of capital if it is first required to offer all new shares to the holders of all classes of stock. The doctrine of the preemptive right is now interpreted to mean that the directors in each case must act fairly towards all groups of stockholders.

Stock rights are bought and sold in the market. When stock is offered to stockholders, the price may be the par value of the stock or any other amount below the prevailing market price. The right to subscribe to the additional issue has a value and the stockholder may exercise the right himself or he may sell it. Sometimes the corporation will effect purchases and sales of rights as a service to stockholders, but more often the shareholder must place his orders with a broker who executes them on the stock exchange.

When stock rights are announced, the corporation fixes a future date as the day for determining who is entitled to them. This is necessary because the shares of many corporations are bought and sold every day. The rights are issued to stockholders listed on the records of the corporation as owning stock at the close of business on the date designated. Until that time, the stock is sold rights on, which means that the rights go with the stock. After that date, the stock is sold ex-rights, that is, without the rights. Rights are mailed later to all persons who owned shares on the date the stock went ex-rights even though some of those persons may have sold their stock before the rights were mailed.

The value of a stock right is computed by subtracting the offering price of the new stock from the prevailing market price rights on, and dividing the difference by one plus the number of old shares required to purchase one new share. For example, if the stock is selling in the market for $184 and the corporation offers its stockholders the right to subscribe to one new share at $100 for each six shares held, the value of the right issued for each share of old stock would be computed by dividing $84 by seven. The reason for adding one to the number of old shares entitled to purchase one new share is that after the issue of the new stock, the surplus of the corporation must be allocated to a larger number of shares and the

stock is in a measure diluted. Immediately after the issue of the rights in the case just cited, the price of the stock might be expected to decline to $172.

The stockholder has the right to sell his stock. The right of the stockholder to sell his stock to whomever he chooses is not subject to restriction by the corporation, and the corporation may be compelled to transfer the stock on its books. It may protect itself by requiring proof that the person who desires to have the stock transferred to his name really has title to it; for if the corporation transfers stock on its books when the transfer has been improperly made or the transferor has not had legal title to the stock, the corporation is liable. This sometimes happens, particularly in the settlement of estates, when the administrator of the estate lacks authority to assign the stock, or the provisions of the will have not been complied with. Since the same stock cannot be held by two people, the original owner of the stock retains his title to it and the corporation will be required to restore the stock or its cash value to him.

In the close corporation, which is a corporation in which the stock is held by only a few persons, the stockholders may agree with each other not to sell their stock without first offering it to the corporation or to the other stockholders. If a stockholder wishes to sell his stock, he agrees to offer it to the other members at the same price as the outsider offers to pay. This agreement is binding as between the stockholders; but if some other person should buy the stocks without knowledge of the agreement, he could compel the transfer to be made on the books of the corporation.[6] However, since few persons would be willing to buy stock in a corporation in which court action is necessary to secure a transfer, the restriction upon the right to sell stock may in fact be effective. The stock certificate may contain a statement that the stock can be transferred only with the consent of the directors. This brings notice to prospective buyers that the right to transfer has been restricted, and it is usually sufficient to prevent the sale to outsiders.[7]

The stockholder usually receives a stock certificate. In the United States, though not in all foreign countries, corporations usually issue stock certificates which are used as evidence of ownership. One reason for the use of stock certificates is that they

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[6] Robertson *v.* Nicholes Co., Inc., 253 N.Y. Supp. 76 (1931).

[7] Lawson *v.* Household Finance Corporation, 152 Atl. 723 (Delaware, 1930). See also "The Transfer of Stock," *Georgetown Law Journal*, March, 1937, Vol. 25, pp. 729-733.

greatly facilitate the mechanical and clerical work involved in the purchase and sale of stock on the exchanges. However, the certificate is not the stock but only evidence of its ownership, and a person who owns stock is entitled to all of the rights and privileges appertaining thereto regardless of whether he has actually received a certificate. For example, it has been held that if stock has been sold but the transfer has not been registered on the books of the corporation, the right to vote the stock is with the buyer and not the seller.[8] When stockholders' meetings are called, the directors usually announce that proxies will be mailed to stockholders of record of a certain future date.

III. The Liabilities of Stockholders

When the subscriber makes his subscription to the stock of the corporation, he usually becomes liable to the corporation only for the purchase price of the stock. Sometimes payment may be made in installments payable on certain stipulated dates or payable upon call at dates to be fixed by the board of directors. In any case the subscriber is in most cases liable to the corporation only for the purchase price of the stock.

If a corporation becomes insolvent and is unable to meet the claims of its creditors from its own assets, the stockholders may under some circumstances be assessed to pay the debts of their corporation even though they have paid the corporation the price which they had agreed to pay for their stock. There are three circumstances under which the stockholder may be liable for an additional amount:

1. If he bought the stock at a discount—that is, paid less than par value for the stock—he is liable for the discount. If the stock has been sold to an innocent purchaser who had no knowledge that the stock was originally sold at a discount, the transferor remains liable, though in some states the liability is lost.

2. Some states by statutory provision make the stockholders liable for certain amounts in addition to the par value of their stock. Formerly in a few instances the stockholders were made liable for additional amounts beyond the par value of their stock, the last states to remove such liability having been California and Minnesota. The constitution of Minnesota formerly provided that

[8] *In re* Canal Construction Co., 182 Atl. 545 (Delaware, 1936).

each stockholder in a corporation, except those corporations organized for the purpose of carrying on any kind of manufacturing or mechanical business, was liable for an additional amount equal to the par value of the stock held by him. This provision was repealed in 1930. It was found that the provision failed to accomplish the security for creditors which had been contemplated, as increasing court costs consumed a large part of the sums obtained from stockholders. The less stringent requirements of other states also caused many businesses to go outside the state for their charters.[9] A similar provision in the California law was repealed in 1931.

In some states stockholders are made liable for debts due from the corporation to laborers, servants, or employees of the corporation. This liability does not depend upon the existence of any unpaid subscription but is a liability of all stockholders. Stockholders may also be liable for the debts of the corporation if the incorporators have failed to comply with the law of incorporation, as in the failure to give due notice to the public of the formation of the corporation or to file a copy of the certificate of incorporation with the proper authorities, or in the beginning of business before the minimum amount of capital required by law has been paid in.[10] If a corporation is dissolved and the assets are distributed among the stockholders, leaving corporate taxes unpaid, the stockholders may be required to pay the taxes.[11]

3. In some cases when stock has been issued in exchange for assets at a gross overvaluation, stockholders have been held for the losses of creditors who relied upon the financial statements of the corporation in making loans. If the appraised value of the assets is substantially less than the par value of the stock, the stock is watered and may be held to have been issued at a discount even though the assets are set up on the books at the par value of the stock. The transaction may also be held to constitute a fraud upon creditors, to which the stockholder is a party.

A purchaser of stock ordinarily assumes little liability for watered stock. In most cases the value placed by the directors upon the property received in exchange for the stock is accepted as conclu-

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[9] Comment in *Minnesota Law Review*, January, 1931, Vol. 15, p. 222.

[10] See for example, Clinton Novelty Works *v.* Neiting, 134 Iowa 311, 111 N.W. 974 (1907).

[11] Phillips *v.* Commissioner of Internal Revenue, 283 U.S. 589 (1931).

sive, and in the absence of fraud neither stockholders nor directors are liable. The statutes of a number of states expressly provide that in the absence of fraud the judgment of the directors as to the value of property must be accepted as final. In fact, in many states the stockholder is liable only for the purchase price of his stock.

Questions

1. What is a share of stock? What is a stock certificate?
2. Distinguish a share of stock from a bond. Distinguish dividends on stock from interest on bonds.
3. How is the income and the income tax of a corporation affected by the issuance of 5 per cent non-participating preferred stock instead of 5 per cent debenture bonds?
4. If a corporation is liquidated, can the common stockholder expect to be paid the par value of his stock? The preferred stockholder? Would the bondholder be certain to be paid in full?
5. Why do corporations issue so many kinds of securities? Would it be better if all of their capital could be raised by common stocks with no bonds or preferred stocks?
6. Name and distinguish the four kinds of stocks from the point of view of voting rights.
7. What is the argument for no par stock? What are the objections to it?
8. Under what circumstances might a corporation issue common stock with a par value of one cent or one mill?
9. What rights do stockholders exercise as a group?
10. What are the individual rights of stockholders?
11. What devices have been used by managements to retain control of corporations with a small investment in the stock?
12. What information must the corporation furnish the stockholders when proxies are solicited?
13. What was the objection of the courts to the voting trust when the device was first introduced?
14. How may the management take advantage of the small stockholder, in the absence of government regulation?
15. What has the government done to protect the corporate stockholder?
16. What corporate records does the stockholder usually have the right to inspect?
17. What is the preëmptive right? Why is it important?
18. Name five exceptions to or limitations upon the preëmptive right.
19. What is a stock right? How is its value determined?

20. A corporation issued rights to purchase one new share for each four held. At that time the stock was selling in the market, rights on, at $140 per share. What was the market value of the right? What would be the value of the stock ex-rights?

21. What is the advantage to the stockholder in the practice of issuing stock certificates? What is the advantage to brokers?

22. Under what circumstances is the stockholder liable for assessments by the corporation?

23. Five persons operate a business as a partnership, each of them having an investment in the business of $15,000. One of the partners is incompetent but insists upon taking an active part in the management of the business. Several contracts which he made in the name of the company proved to be unprofitable. By general agreement, the business is incorporated. How is the relation of the former partners to the business affected?

CHAPTER X

Bonds and the Bondholders

The permanent capitalization of a corporation may consist of both bonds and stocks. The two types of securities differ in that the bond is a liability and the stock represents a part ownership in the corporation. The bond is contractual. It is an obligation to pay a fixed sum of money at a designated date in the future, which is the maturity date, and to pay a stated amount of interest at stipulated dates prior to maturity. The stock is not contractual but residual. It does not entitle the owner to receive a fixed sum at any time in the future but only a prorata amount after all prior claims have been paid.

The bondholder is not a part of the corporate organization in the sense that he ordinarily has a voice in the formulation of corporate policies. Some state incorporation laws permit the bondholder to vote at stockholders' meetings if the charter so provides; and in the case of receivership and reorganization, the bondholder may participate through the agency of the trustee. However, bond issues and bond investors play an important part in the financing of corporations.

I. Uses and Types of Bonds

Many corporations, particularly those engaged in manufacturing and merchandising activities, issue only small amounts of bonds or no bonds at all. Real estate, public utility, and railroad corporations raise a substantial part of their capital through bond issues. The authorization for an issue of bonds and the limits upon bonded indebtedness are usually stated in the corporate charter.

Bonds may be used to advantage in raising a part of the capital of the corporation. There are several reasons for the use of bonds. First, additional sources of capital may be tapped. Many individuals and institutional investors prefer bonds, and some are not permitted by law to purchase stocks. These include savings banks,

insurance companies, commercial banks, trust companies, universities, and other endowed institutions. As long as investors demand bonds as a means of investing their funds, corporations are likely to continue to issue them. Second, the corporation whose stock is selling in the market at less than par value may be unable to raise more capital by the issue of stock because of the contingent liability of the purchasers for the discount. If the corporation cannot change to no par stock, it may be forced to resort to bonds. The railroads have frequently found themselves in this situation. Third, the issue of bonds bearing a low rate of interest will increase the net income available to stockholders, provided the corporation can earn more on its capital than the rate of interest on the bonds. For example, if a corporation can borrow funds at three per cent interest and use the money in the business to earn five per cent, there is a net income of two per cent which will increase the amount available for dividends on the stock or for reinvestment as permanent capital of the corporation. Fourth, interest payments are an expense and therefore are deductible from income for tax purposes, whereas dividends are a distribution of profits and are not deductible. This may cause bonds to be issued instead of common stock and particularly instead of preferred stock.

Bonds carry risks for the issuing corporation. The reason for the limited use of bonds by industrial corporations is that the bond interest is a fixed charge which must be met in bad times as well as good. The bond issue also has a maturity date which might happen to be at a time when refinancing would be difficult. Moreover, a corporation which has only one type of securities outstanding treats all security holders alike. All participate prorata in the prosperity of the corporation and all share alike in the effects of adversity.

Bonds are issued in several denominations. A most common denomination is $1,000, and this is the unit of trading on the New York Stock Exchange. Bonds may be issued in denominations of $500, $100, or even $50. Such bonds are referred to as *baby* bonds. Larger denominations than $1,000 may be provided for large investors, including institutional investors.

Bonds may be registered or coupon bonds. A *registered* bond, as the name implies, is registered in the name of the owner on the books of the corporation. The holder of the bond receives an engraved certificate similar to the certificates issued to stockholders, and interest payments are mailed at each interest date. Transfers

of the bonds are made by the endorsement and surrender of the bond certificate, a new certificate being issued in the name of the purchaser. To prevent fraudulent issues of bonds, transfers are effected by a transfer agent, usually a bank or trust company, acting for the corporation. A second trust company or bank registers the bond certificate, and transfers are not complete until the new certificate has been certified by both the transfer agent and the registrar.

Coupon bonds carry coupons which may be clipped and deposited in a bank for the collection of interest. Each coupon indicates the date when it becomes due and payable and carries the name of the debtor corporation and of the bank which acts as its fiscal agent. Coupon bonds are transferable by delivery, and no endorsement is necessary. Bonds may be registered as to principal even though interest is payable by coupon. Most bonds are coupon bonds. They are more convenient for the corporation and for brokers and possibly for investors also.

Bonds may or may not be secured by a pledge of corporate assets. If a bond issue is secured, the lien may cover either personal property or real estate. Personal property pledged is frequently the securities of other corporations. Bonds which are secured by stocks and bonds are called *collateral trust* bonds. Railway corporations frequently give a pledge of rolling stock, the bonds being called *equipment trust* bonds or *car trust* bonds. Any real estate may be pledged as security for a bond issue, and the bonds may be designated as *divisional* bonds, *bridge* bonds, *terminal* bonds, *real estate mortgage* bonds, or other such name which indicates in a general way the type of property pledged. If the bond is secured by a first mortgage, it may be called a *first mortgage* bond, a *prior lien* bond, a *senior* bond, or an *underlying* bond. Bond issues which are secured by a second or later claim upon property may be designated as *second* or *third mortgage* bonds, *junior* bonds, or *overlying* bonds. A junior lien bond may become a prior lien bond after the earlier issues have been retired. A bond issue which carries a first mortgage on some units of property and a second mortgage on others may be called *blanket mortgage* bonds, *consolidated mortgage* bonds, *general mortgage* bonds, *general and first mortgage* bonds, or *first lien and general mortgage* bonds.

A bond issue which has no designated lien upon any assets but depends for its security upon the earnings of the corporation is spoken of as a *debenture* bond or an *unsecured* bond. If a bond was

issued by a predecessor corporation, it is spoken of as an *assumed* bond. Debenture bonds, in case of default, would rank after mortgage or other prior lien bonds. To protect the investor in the debenture bond, the right of the corporation to issue additional mortgage or other prior lien bonds may be restricted by contract. In any case, a bond cannot be adequately described by a word or phrase. Its soundness depends upon many factors surrounding the issue.

II. The Issue of Bonds

Bonds are issued upon the authorization of the board of directors in accordance with the provisions of the corporate charter. They are usually marketed by investment bankers who may or may not submit competitive bids for the issue. Frequently, the corporation has established relations with a banker who submits the only bid. After a proposed issue has been examined by the attorneys of the corporation, the plans may be submitted to the stockholders for their approval. Appraisals of corporate property are made and financial reports are prepared preliminary to the marketing of the issue. The investment bankers may also wish their attorneys to examine the legality of the issue, to establish the title of the corporation to the property to be mortgaged, and to arrange other legal details. After the preliminary investigations and authorizations have been completed, a contract is signed with the investment bankers providing for the underwriting and sale of the bonds. The contract indicates the price of the bonds and the date or dates when the funds are payable to the corporation.

The corporation must coöperate with the bankers in qualifying an issue under state and Federal laws. To qualify an issue under state securities legislation means that it must be registered and the necessary information filed with the state securities commissioner. As the details of the state laws vary, the requirements of each state must be anticipated and the information compiled in advance of the date for marketing the securities. The Securities Act of 1933 requires that a registration statement containing certain information and documents be filed with the Securities and Exchange Commission. If an issue is to be listed on a securities exchange, application must be made to the officers of the exchange and information pertaining to the corporation and the issue be

filed with them. The bonds are then engraved, signed by the officers of the corporation and the trustee, and delivered to the bankers who make payment at the stipulated date.

A trustee is named to represent the bondholders. All of the bonds sold constitute a single issue, but they are held by many investors. The bondholders are not in a position to assure themselves that the corporation is living up to its obligations in connection with the bond issue, and the issuer might be seriously inconvenienced if it were required to deal with numerous investors. Consequently a trustee is appointed as a part of the procedure for issuing the bonds. It is his duty to see that all provisions for the protection of the bondholders are complied with. The dealings of the bondholders with the corporation are through the agency of the trustee. The name implies that he is expected to exercise care, diligence, and wisdom in his activities. The trustee may be a natural person; but since the responsibility is a continuing one, a corporation with continuous life is preferable. Usually the trustee is a trust company or the trust department of a commercial bank.

The obligations of the corporation are stated in the trust indenture. The trust indenture is a contract between the corporation and the trustee acting in the interests of the bondholders. It is usually a lengthy document, sometimes a hundred pages or more in length. It states in legal terms the obligations of the corporation. In it the corporation covenants to do certain things to protect the interests of investors in the bonds. A summary of the provisions of the indenture is printed on the face of the bond. The indenture may contain such provisions as the following:

Provisions of the Trust Indenture

The name of the issuer and the trustee.

The total amount of bonds authorized in the issue.

The date of the bonds, the maturity date or dates, and the dates of the interest payments.

A description of the property pledged as security for the loan.

An agreement by the corporation not to issue any bonds with a prior lien unless a certain amount of property is acquired in exchange. The corporation may also agree to permit the present issue of bonds to become a senior lien when earlier issues have been retired.

An agreement to give the present issue a first lien on any property which may be subsequently acquired by the corporation.

Provision for the issue of additional bonds at a later date provided the income of the corporation has increased a specified amount prior to issuance.

Provision for the redemption of the bonds in installments prior to the maturity date.

Provision for the accumulation of a fund to be used for the repayment of the bonds at maturity or in installments prior to maturity.

An agreement by the corporation to keep the property in good operating condition, to make necessary repairs, to keep taxes paid, and to carry adequate property insurance.

An agreement by the corporation to charge depreciation of the property pledged as security. This provision is designed to prevent the payment of dividends out of capital.

An agreement to maintain current assets in a specified ratio to current liabilities, or fixed properties in a certain ratio to bonded indebtedness.

Provision for the substitution of collateral, in the case of a collateral trust bond. Substitution is necessary in case any of the bonds in the original deposit are called for redemption or they mature. The corporation may also find it desirable to sell some of the securities, and in that case additional deposits should be made.

Provision for the acceleration of the maturity date if the corporation fails to keep up repairs or violates any of the provisions of the indenture.

The trust indenture provides for a conditional transfer of title to property to the trustee. If property is pledged as security for a bond issue, the trust indenture provides for a conditional conveyance of title to the trustee for the benefit of the bondholders. The debtor corporation retains possession of the property and continues to use it so long as payments are made as agreed. If the corporation makes all payments, the transfer of title never becomes actual. If payments are not made, the trustee may foreclose, take possession, and sell the property for the benefit of the bondholders. This provision is similar to the usual real estate mortgage. The difference is that the corporation deals with the trustee instead of dealing directly with each creditor.

III. Retirement of Bonds

Although some bonds have no maturity date and thus may be outstanding in perpetuity or for an indefinite period, most bonds mature at a specified time which may be twenty or more years after the date of issue. Bonds may be retired by payment at maturity, by payment prior to maturity through the right of the corporation to call its bonds for payment, by purchase for retirement in the

open market, and by conversion into preferred stock or other junior security at the option of the bondholder.

Bonds are often paid at maturity through a refunding issue. To refund an issue of bonds means to market a new issue to pay off the earlier one. Refunding may be good policy if the corporation has a continuing need for the funds provided by the original issue. To illustrate, if a corporation has a total capital of $100,000,000 of which $30,000,000 was provided by bonds and the balance by preferred and common stock, it may need the same amount of capital after the bond issue has matured. If the original issue represented sound financing, a new issue may be equally wise. The fact that the first issue has a maturity date enables the corporation to make a fresh appraisal of the situation and to formulate a new policy if it appears desirable.

A refunding issue may provide for the repayment of two or more issues. If two issues of bonds do not mature at the same time, the refunding bonds may be authorized in the bond indenture and a part of the bonds held by the trustee until later issues mature.

A fund may be provided for the payment of bonds at maturity. The corporation may anticipate the maturity of a bond issue by accumulating a fund through periodical payments. The payments into the fund may be made annually to a trustee who invests the money in other corporate securities, in municipal bonds, or in government bonds. Interest earned on the securities in the fund may be added to the fund to accelerate the accumulation of the fund. If the periodical payments into the fund are equal in amount and if the interest is added to the fund, the fund is spoken of as a *sinking fund.* Otherwise, it is called a *redemption fund.*

When the sinking fund is set up, the total capital requirements of the corporation may be maintained by making the fund payments from sums provided by profits. To return to the earlier illustration, a corporation which originally had total assets of $100,000,000 with outstanding bonds of $30,000,000 may provide for the retirement of the bonds by retaining a part of its annual profits in the business. The profits may thus be paid to the trustee for bond retirement instead of being used for dividends or for the expansion of plant facilities. To indicate to stockholders and creditors that the corporation has used the profits to establish the fund, a reserve for sinking fund may be set up by vote of the board of directors. When the fund and the reserve amount to $30,000,000, the balance sheet might be as shown in the accompanying illustration.

AN INDUSTRIAL CORPORATION

BALANCE SHEET — DATE OF MATURITY OF BONDS

Assets		*Liabilities and Capital*	
Property and Equipment	$100,000,000	Bonds Payable	$30,000,000
Sinking Fund	30,000,000	Capital Stock	70,000,000
		Reserve for Sinking Fund	30,000,000
Total	$130,000,000	Total	$130,000,000

When the fund has been expended to retire the bonds, the fund and the bonds would disappear from the balance sheet, leaving total assets of $100,000,000. The reserve remains on the books, but it should be returned to the earned surplus. It may then be used as the directors decide, but an acceptable use for at least a part of the amount of the reserve might be a dividend payable in stock.

The bonds may be called for payment prior to maturity if the indenture so provides. Some bonds are callable at the option of the corporation and some are not. It is usually a disadvantage to the investor to have the bond made callable, unless he is paid a premium, for the decision to call and the fixing of the time for calling rest with the corporation. The option to call may be exercised if the corporation no longer has need for the funds provided by the bond issue, or if the bond market changes to permit a new issue at a lower rate with a net saving to the corporation. Because the option may be used to the disadvantage of the investor, the bonds are usually made callable at a price above the issue price and possibly above par value. The investor therefore has a profit if the bond is called prior to maturity.

Bonds may be retired in installments. The bond indenture may make provision for the payment of the bonds in installments by arranging for the maturity of some of the bonds at definite intervals, usually at each interest date. The indenture may also provide for the drawing of lots to determine which bonds shall be called for payment at each date. The numbers drawn may be published in a newspaper and also printed on a sheet for distribution to bond houses and to investors in so far as their names are known. Since the redemption price is higher than the issue price, it may be to the advantage of the investor to have his number drawn; but if the bond market has changed materially and the bond has advanced in price, it might be to his disadvantage to have his number drawn. Bonds which are paid in installments are sometimes referred to as *sinking fund* bonds, but this name should be

reserved for bonds paid at maturity through the accumulation of a fund of cash and securities.

Bonds may be retired through purchase in the securities markets. The corporation may avoid the risk incident to the obligation to retire a fixed amount of bonds each year by using its spare funds for purchases of its own bonds in the open market. In years when it has cash, it can buy its bonds in large or small amounts as its finances permit; and in years when it is hard pressed for cash, it can decrease or discontinue its purchases. It may even resell some of the bonds purchased in earlier years. Many corporations whose bonds have suffered marked declines in price have repurchased them to the advantage of the corporation. However, the decline may be the result of financial difficulties and operating losses of the corporation, which would mean that the corporation lacks the cash for buying its own bonds.

When a corporation builds up a sinking fund for the repayment of its bonds at maturity, its own bonds may offer the most attractive medium for investment. The reason is that the saving in bond interest is certain when it buys its own bonds, whereas the income on the bonds of another corporation is uncertain. There is usually a limit to the amount of its own bonds which a corporation can buy to advantage because its bidding runs up the price. Many of the bonds may be held by investors who continue to hold them for income even though the corporation bids for them and despite a price advance.

Bonds may be converted into stock. The bond indenture may give the bondholder the option of surrendering his bond to the corporation for conversion into preferred or common stock. This conversion would be unprofitable at the date of issue of the bonds because of the ratio of conversion, but the conversion right gives the bond a speculative value in addition to its value as an investment. For example, bonds might be issued at par with the stipulation that they may be converted into common stock at $180. This would mean that $18,000 of bonds may be converted into common stock of a par value of $10,000. If the bonds as an investment continue to be worth par value, they could profitably be converted into common stock if the price of the stock advanced above $180 per share. The bonds would not necessarily be converted as soon as the stock touched that figure, for many bondholders would wait to see whether the advance in the price of the stock was temporary and speculative in nature or whether it appeared to be permanent and

to reflect an improvement in the prospects for earnings and dividends. In any case, the advance in stock prices would affect the prices of the bonds as the stock approached the point where conversion would be profitable. During periods of active stock speculation, convertible bonds have carried a strong appeal to investors.

IV. Bond Defaults and the Protection of Bondholders

It is expected that bonds will be paid at or prior to maturity, but that may not be possible. A corporation may find itself unable to meet the interest charges long before the bonds mature, or it may meet all interest charges but be unable to pay the principal. In that case the holders of bonds may assert their rights as creditors, acting through the agency of the trustee.

Certain rights of the bondholders are inherent in their position as creditors. When a debtor is unable to pay his liabilities, he may refuse to pay and admit his inability to do so. The creditors may then set in motion the legal machinery for collection of such amounts as they may be able to get. They may levy upon his assets which they may sell in partial or full settlement of their claims. If the debtor has transferred any property to other persons for the purpose of defrauding the creditors, they may require that the property be returned to the corporation and used to liquidate their claims. They may require that all creditors be treated equitably, and to assure such treatment they may ask that the court appoint a receiver to protect the property and to use it to pay the debts according to law. Any mortgage preferences would be recognized.

The bondholders have additional rights under the indenture. The trust indenture gives the bondholders certain preferences, such as a lien upon land and buildings and possibly other assets, including securities. This means that such assets as are pledged may be seized by the trustee and sold to provide funds for the settlement of their claims. Such a procedure would usually be disadvantageous to the interests of the bondholders themselves, however, for it is usually better to reorganize the capitalization and to keep the assets together as a going concern. Much modern corporate equipment is specialized and can be most effectively used in that business for which it was originally built or designed. Consequently the lien of the bondholders upon the assets is usually of value to them in giving them a greater voice in the reorganization of the corporation.

The bondholders expect the trustee to protect their interests. The bondholders cannot act for themselves either before or after a default by the debtor corporation. They must look to the trustee who is expected to see that the provisions of the bond indenture are carried out. While they may by petition compel the trustee to foreclose or to take other action for their protection, a specified percentage of the holders of the outstanding bonds, usually twenty-five per cent or more, is required. This percentage is impossible of attainment because of inertia and the lack of knowledge on the part of investors.

The trustee may neglect to see that the corporation complies with the indenture. Trustees under bond indentures have not always exercised the care and diligence in the execution of their duties which the bondholders have a right to expect. To be sure, in most cases the corporation has lived up to its indenture agreements, and no action by the trustee was required. When the corporation has failed to do so, the trustee has not always done all that could be expected of it. Outstanding instances of neglect have been in connection with real estate issues, particularly in connection with bonds of apartment houses and office-building corporations.

One of the first obligations of the trustee is to see that the proceeds of the bond issue are applied to the purposes specified in the indenture, such as the repayment of an earlier issue or the construction of a building. Lacking supervision by a careful and diligent trustee, the issuer may fail to erect buildings or acquire properties or retire earlier issues as agreed. Instead, the corporation may divert the proceeds to other purposes.[1] Taxes may later go unpaid and the property may be taken over for non-payment of taxes without action by the trustee.[2] Needed repairs may be neglected, and sinking fund payments may be passed. Issuers have even defaulted on their interest payments without the holders of the bonds being aware of that fact. Their interest payments may be made from funds advanced by the investment banker who marketed the issue and who is desirous of maintaining an unbroken record of avoiding losses to investors. Since the money for interest payments on one issue is taken from the proceeds of the sale of another issue, the effect is only to postpone the day of reckoning

[1] Securities and Exchange Commission: *Report on the Work of Protective and Reorganization Committees,* Part VI, p. 30. Government Printing Office, Washington, 1936.

[2] *Ibid.,* p. 31.

and to multiply the inevitable losses.[3] Trustees have at times failed to inform holders of bonds of actual or impending defaults and have also failed to take action to protect their interests, thus lulling the bondholders "into quiescence about the situation." [4] To relieve the trustee of any possible liability in such cases of neglect, the indenture may contain various clauses known as exculpatory clauses. As a further barrier to any liability, the trust indenture may provide that the trustee has no obligation to take any action which may involve it in expense or liability unless the security holders agree to indemnify it. In the nature of the case, this is usually impossible.

Part of the difficulty has arisen from the lack of independence of the trustee. Although the trustee is regarded by the bondholders as their legal representative, it has sometimes been closely identified with the underwriter or the issuer. It may in fact have been the underwriter or a stockholder in the underwriter. It may be affiliated with the underwriter or the issuer through the device of common officers or directors.[5] The trustee may therefore be more interested in protecting the issuer or the underwriter than it is in safeguarding the interests of investors. Conflicting interests may also arise if a bank serves as trustee for two or more bond issues and two or more groups of security holders whose interests are not identical.

The law now requires that the trustee be independent. The Trust Indenture Act of 1939 established new requirements for trustees under indenture bond issues of $1,000,000 or more. The Act requires that at least one of the trustees must be a corporation which is authorized to exercise trust powers, with a capital and surplus of at least $150,000. The trustee is disqualified if it has any interest which conflicts with the interests of holders of securities issued under the indenture. It is deemed to have such conflicting interest if it is the issuer, or if more than one of its officers or directors are also officers or directors of the issuer. The trustee cannot be under common control with the issuer. A trust company or bank cannot act as trustee under two or more mortgage bond issues of the same corporation. A number of other similar provisions are designed to assure the independence of the trustee, such as the requirement that the trustee cannot be the owner of more

[3] *Ibid.*, pp. 32-37.

[4] *Ibid.*, p. 41.

[5] *Ibid.*, p. 123.

than five per cent of the voting securities of another corporation which in turn owns securities of the issuer.

Bondholders are entitled to corporate information. To facilitate the supplying of information to bondholders, the Trust Indenture Act requires that the issuer supply the trustee with such lists of bondholders as are available, and three or more bondholders who apply may have access to the lists. The indenture trustee is required to make annual reports to bondholders with respect to any unpaid advances made by the trustee to the issuer, any property pledged as security for such advances, any changes in real estate or collateral pledged as security under the bond indenture, any additional issues of securities under the indenture, and any action taken by the trustee in the performance of its duties. The debtor corporation is required to file with the trustee annual reports containing information of any changes affecting the securities issued under the indenture, and summaries of such reports must be supplied the bondholders by the trustee. In case of default, the trustee is required to render notice to investors; and in case of impending default known to the trustee, similar notice must be given unless the trustee believes that such notice would not be in the interests of the bondholders themselves. The trustee is required, in case of default, to use the same degree of care and skill in the exercise of its powers as a prudent man would use in similar circumstances in the conduct of his own affairs.

The Trust Indenture Act of 1939 will undoubtedly correct many of the evils formerly associated with bond indentures. It still behoves the prospective bondholder to beware, however, for his security continues to be the earning power of the corporation and of the assets pledged as security.

Questions

1. What is meant by the capitalization of a corporation?

2. Does the bondholder ever have a part in the determination of the financial policies of a corporation?

3. What are the advantages to a corporation in raising all of its permanent capital by the sale of stock? Why is it sometimes better to sell bonds to raise a part of the capital?

4. Should a bond issue have a maturity date? How should the date of maturity be determined? Does the maturity date depend upon the useful life of the assets purchased with the proceeds of the bond issue?

5. What are the advantages to the corporation, to brokers, and to investors of the coupon bond?

6. Distinguish between a debenture bond, a collateral trust bond, and a mortgage bond. Does the security pledged indicate the value of a bond as an investment?

7. If a bond carried a junior lien upon property, would it be designated as a third or fourth mortgage bond? What name might be given to such a bond?

8. Trace the procedure for the authorization and sale of bonds.

9. Why is a trustee appointed to represent the bondholders?

10. Who are the parties to a trust indenture?

11. What provisions are usually included in a bond indenture?

12. Should a corporation make provision for the retirement of a bond issue by the accumulation of a sinking fund? What is meant by the provision that a sinking fund should be set up "out of profits"?

13. What is meant by the refunding of a bond issue? When is refunding prior to maturity advisable?

14. Distinguish between a sinking fund and a redemption fund.

15. Why might a corporation find it good policy to purchase its own bonds instead of purchasing the bonds of another corporation?

16. What are the duties of a trustee prior to the default of a bond issue?

17. What are the duties of the trustee at the time of a default in interest payments or in the payment of the principal of a bond issue? What are the duties after a default?

18. Why is it important that the trustee be independent of the issuer? Why should the trustee be independent of the investment banking house which underwrites and sells corporation bonds?

19. What are the principal provisions of the Trust Indenture Act of 1939?

20. To what information is a bondholder entitled? Contrast with information which is of interest and value to the stockholder.

CHAPTER XI

Regulation of the Issue and Sale of Securities

The general incorporating acts are not designed to protect the purchaser of securities. With few exceptions, notably Pennsylvania, corporations are not required, as a condition of their incorporation, to render financial statements to stockholders or to prospective stockholders. They render reports only to the state, and these are designed solely as an aid to the officials in the collection of franchise and other corporate taxes. For the protection of investors, it has therefore been necessary for both the states and the Federal government to enact legislation to deal with the problem of the sale of securities.

From the point of view of risk to the purchaser, there are three classes of securities: (1) fraudulent, (2) highly speculative, and (3) high-grade securities. Fraudulent securities are those sold through misrepresentation or deceit. The proceeds of sale usually go to benefit the officers of the company. Such securities afford no prospect of success. Highly speculative securities involve a high degree of risk, but they represent issues of honest or reputable companies. The proceeds of sale are used for business purposes as represented to the purchaser, but the chances of failure are large. High-grade securities are those issued by established companies with satisfactory records of earnings and dividends. High-grade securities may be either stock or bonds. They are sold by reputable investment bankers and may be listed on a stock exchange. Losses may be sustained through investments in high-grade securities, but they are less likely than investments in low-grade securities.

Many high-pressure methods have been used in selling fraudulent securities. In the sale of fraudulent securities and sometimes in the sale of highly speculative securities, salesmen have developed many adroit methods. While a complete list is impossible, the following are suggestive:

1. The purchaser may first be sold a small block of a high-grade

security, or possibly a worthless stock, on which he is permitted to make a profit. This is easily arranged by the sales office which may create a fictitious market and buy the securities back at an increase in price. The purchaser is then induced to make a large purchase of worthless securities.

2. If the investor can be persuaded to buy a small amount of stock, he may be induced to pay additional sums to the corporation as assessments or for additional shares on the plea that such payments are necessary to protect the original investment. In many cases these payments amount to no more than throwing away good money in a hopeless effort to save what is already lost.

3. The pride of the prospective purchaser may be appealed to by the false representation that he has been selected as a prominent citizen to buy at a special price. This method has been used in the sale of some high-grade securities, but any person who is offered shares below what is represented to be the price to the general public should examine the proposition very critically.

4. The prospective purchaser may be offered a block of stock free with the understanding that certain small assessments may be made by the board of directors. In the aggregate, such assessments may be substantial.

5. After a small initial purchase by the investor, dividends may be paid by the company, not out of earnings, but out of the proceeds of sale of the first shares. In this way, the purchaser and his friends may be induced to purchase additional shares in large amounts.

6. High-grade securities may first be sold to the prospect. Later he is told that he can increase the yield by selling the securities purchased earlier and investing the proceeds in some other recommended securities. The second lot may be worthless. This is the "sell and switch" racket.

7. The "boiler-room" method is the use of the telephone as a means of putting continuous pressure upon a prospect. The "boiler-room," the place where the "heat" is turned on, is an office whose equipment consists largely of a battery of telephones. Boiler-room methods are usually used in conjunction with certain other methods, such as personal solicitation, letters, and telegrams.

In the absence of specific legislation, the purchaser of securities has scant protection. The person most likely to deceive the pur-

chaser of stock is the salesman. To hold the salesman liable in damages, however, it was necessary, prior to the enactment of state and Federal laws, to prove: (1) that the salesman had misstated a fact concerning the security; (2) that the fact misstated was material and not trivial, or, in other words, that if the fact had not been misstated, the purchaser would not have bought the stock; (3) that the purchaser believed and relied upon the misstatement; and (4) that the purchaser had no way of verifying the statement made or of finding out the truth for himself. Since the purchaser had to prove all four contentions, it is obvious that in most cases he could not succeed.

Prior to 1931, accountants and lawyers who prepared data used in the sale of securities were not liable to investors. The prevailing doctrine was that these and other experts were employed by the corporation and not by the investor. Consequently, the courts said that such persons owed no duty to outsiders because they had no contract of employment with them. In 1931, in a famous case decided in New York state,[1] it was held that the accountant was liable if he had been grossly negligent in the preparation of financial statements or if the accountant had prepared and signed statements which he knew to be false, provided third parties had relied upon his statements in making loans. The case involved a creditor, not a stockholder, but once the principle of liability of the accountant to a third party was established, the liability might extend to a stockholder also.

Bankers and others who prepared the prospectus used in the sale of securities usually undertook to evade any liability to investors by including in the prospectus a statement to the effect that they assumed no responsibility for the truth of the financial and other data they had prepared. This statement, generally known as a disclaimer clause, ran something like the following:

"The information contained herein, while not guaranteed by us, has been obtained from sources which we believe to be reliable."

The disclaimer clause was considered sufficient to protect the bankers from all liability, provided they really believed the information they prepared. It would be difficult to prove that they did not believe it at the time the prospectus was prepared.

Officers, directors, and promoters had defenses equally as good as

[1] Ultra Mares Corporation *v.* Touche, 174 N.E. 441 (N.Y., 1931).

those available to salesmen, accountants, lawyers, and bankers. Furthermore, any remedy available to purchasers of securities was inadequate because it could be used only after losses had been incurred.

The most effective weapon against securities frauds prior to the enactment of state and Federal securities legislation was the Mail Fraud Act which provided severe penalties for the use of the mails to defraud. This law was only partly successful, first, because its provisions applied to only one kind of fraud, and second, because it was not vigorously enforced in securities cases.

The regulation of methods of selling securities comes from three sources: the states, the stock exchanges, and the Federal government. The stock exchanges are not a public authority, but they are now subject to Federal control and their regulations must have the approval of an agency of the government, which is the Securities and Exchange Commission. The legislation of the states is often called "blue-sky" legislation.

Blue-sky legislation is designed to prevent the sale of fraudulent securities. The purpose of blue-sky laws is to prevent the sale of securities which give the investor nothing of more value than a part of the "blue sky." The sale of highly speculative securities is also regulated by requiring the disclosure of pertinent facts in connection with their issue and sale and by establishing penalties for misrepresentation and deceit. This is usually accomplished through the supervision of dealers, who may be required to obtain a license before they are authorized to sell securities. The license is granted on condition that the dealer comply with certain requirements established by the state. In many states, however, dealers are not required to register, but security issues must be qualified. Qualification usually consists of filing with the state commissioner of securities certain information concerning the issuer and the securities to be offered for sale, paying a filing fee, and obtaining the approval of the commissioner for the offering. In most of the states it is not necessary to file the information for certain types of securities, such as United States and foreign government bonds, stocks of national and state banks and public utilities, and securities traded on stock exchanges.

State blue-sky laws may be grouped into four classes. These are as follows:

1. The fraud type of law, which provides penalties for fraud in

the issue of securities and authorizes the courts to issue injunctions against the sale of fraudulent securities. Under this law, dealers are not required to register or to be licensed, and security issues need not be registered.

2. The inspection type of law, which requires that securities be registered but does not require that dealers be licensed.

3. The licensing type of law, which requires that dealers in securities be licensed but does not require that securities be registered or approved.

4. The licensing and inspection type of law, which requires both that dealers be licensed and that securities be registered and qualified. This is the most common type of law.[2]

Some states attempt to prevent the sale of securities at unfair prices. While the usual purpose of blue-sky laws is only to prevent the sale of fraudulent securities and to require that highly speculative securities be labeled as such, some states require the commissioner of securities to pass upon the fairness of the price at which they will be offered for sale. Thus, the Vermont law authorizes the registration of securities only if the commissioner finds that their sale would not be fraudulent, that the enterprise or business of the issuer is not based upon unsound principles, and that in his judgment the securities promise a fair return to the purchaser. According to the New Hampshire law, the commissioner may prohibit the dealer from advertising or offering an issue of securities for sale if he is of the opinion that there is serious financial danger to the purchaser or that the circulars and advertisements do not disclose pertinent facts sufficient to enable the intending purchasers to form a correct judgment of their value. The Alabama law provides that the commissioner may refuse to qualify securities for any one of several reasons, one of which is that the securities are worthless.

Blue-sky laws have been only partially successful. While state control has undoubtedly prevented the sale of many worthless stocks, there are several reasons why it has not accomplished all that was desired. One reason is that the state has no control over the marketing of securities across state lines. Securities may still be sold through newspaper advertisements and by direct mail without state permission. Securities swindlers may evade state enforce-

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[2] Russell A. Smith: "The Relation of Federal and State Securities Laws," *Law and Contemporary Problems,* April, 1937, Vol. 4, pp. 241-255. Rupert F. Bippus: "Illinois Securities Law," *John Marshall Law Quarterly,* Sept., 1937, Vol. 3, pp. 139-145.

ment officers by moving into another state when they learn that action is about to be taken against them. This requires only a few hours by automobile. A further weakness of state legislation is that it has been directed largely at the regulation of the sale of securities rather than at their issue. After the securities have been issued, the problem of regulation becomes more difficult. Another weakness is that the laws do not attempt to provide security holders with annual financial or other statements.

A fundamental weakness of state legislation has been the number of exemptions. Since it was intended to curb the sale of fraudulent and highly speculative securities, it exempted many issues which were presumed to be high grade because of the circumstances of their issuance or sale, such as those traded on a stock exchange, securities listed in an investment manual, and securities issued by a corporation with a certain number of years' dividend or earnings record. In times of stock market booms, the losses of speculators and investors in such securities were serious. The interests of investors in securities commonly regarded as high grade demanded protection as much as did the interests of purchasers of low-grade securities.

The stock exchanges have rendered valuable service in obtaining information. The New York Stock Exchange, which is by far the most important stock exchange in the United States, has been a leader in the movement for publicity. When it permits a security to be listed for trading, it requires the issuing corporation to file a great deal of information, including a copy of its charter, a statement as to the business of the corporation, the corporate organization, information with respect to each subsidiary, a description of each issue of securities outstanding, a schedule of the debts of the company, a description of property owned, the depreciation policy of the corporation, balance sheets and income statements, dividends paid in prior years, and the output or production record. The corporation must also agree to publish a balance sheet and an income statement at least once a year, to maintain a transfer and registry office in New York City, to notify the exchange of any change in the amount of outstanding stocks and bonds, and to make public any action of the directors and officers with respect to interest on bonds, dividends on stock, or the allotment of stock rights. The information is not published by the stock exchange since the exchange is only a place for trading. However, it is available to anyone desiring it. The exchange does provide facilities for disseminat-

ing information with respect to the prices of stocks on the exchange.

There were serious weaknesses in the control of information by the exchanges. While the information procured for the benefit of investors and traders in securities by the exchange authorities has been of much value, there were numerous limitations. The stock exchange does not have adequate facilities for determining when information submitted is false, and it has no authority to punish criminally officers and directors who submit false or misleading information. If the information submitted by a corporation should later be found to be false, the stock exchange would not be liable since it does not certify the correctness of the statements. Even the requirements of the exchange itself were not always carefully enforced, and issues were sometimes listed which would not have been admitted to trading if the requirements had been properly administered.

A further limitation of the listing requirements of stock exchanges was that the stock exchange made no attempt to obtain information with regard to many of the abuses of management, such as speculation by officers and directors in the corporation's own stock, manipulation of security prices by non-members of the exchange, the charging of excessive fees by promoters and bankers, and the watering of stock. In some cases the exchange failed to require that satisfactory financial statements be published from year to year after the stock was listed. Although the corporation was required to agree to publish annual statements, the statements actually published often gave incomplete and inadequate information. This situation was somewhat improved in 1933 when the New York Stock Exchange adopted the requirement that all financial statements accompanying applications for listing must contain certificates from certified public accountants and that the corporation must agree that future annual statements would be similarly audited. The stock exchanges, in fact, have not paid sufficient attention to the statements published after the listing has been approved, though in some cases the New York Stock Exchange has succeeded in requiring corporations to clarify their statements under threat of striking the stock from the list of securities approved for trading.

Prior to 1934, many stock exchanges admitted securities to unlisted trading at the request of a member of the exchange. Unlisted trading is the buying and selling of a security on a stock exchange even though the security has not met the formal listing require-

ments of the exchange. This means that detailed financial statements of the issuer of the unlisted stock have not been filed with the exchange but the member who requested the unlisted trading privilege filed such information as was available. The New York Stock Exchange has not admitted stocks to unlisted trading since 1910, and at present does not permit any trading in unlisted securities. Most other exchanges have continued their unlisted departments, the New York Curb Market being the principal market for unlisted stocks.

The Federal government now requires that detailed information be published when securities are sold in interstate commerce. Under the Securities Act of 1933, any industrial corporation or any foreign government making a public offering of securities in interstate commerce must register them with the Securities and Exchange Commission and file a prospectus giving certain detailed information. The Act specifies the information which the registration statement must contain but leaves certain details of form and arrangement to the Commission. For a corporation, the registration statement must contain among other things the names and addresses of all persons owning more than ten per cent of any class of its stock and the amount held by each. It must explain or indicate the character of the business transacted by the corporation, the capitalization, the funded debt, the purposes for which the funds derived from the sale of the securities are to be used, the compensation paid to directors and to all officers whose compensation exceeds $25,000 per year, the estimated net proceeds of the sale of the security, and all discounts and commissions paid to underwriters. It must include a balance sheet and a statement of profit and loss certified by an independent public or certified accountant. The prospectus which is issued to the public in connection with the sale of the securities must contain the same information as the registration statement, but the Commission may permit the omission of any information which it deems not to be necessary for the protection of investors.

If a registration statement is incomplete or inaccurate in any material respect, the Commission may refuse to permit the statement to become effective until it has been properly amended. If the Commission finds at any time that a statement includes any untrue statement, it may issue a stop order suspending the effectiveness of the registration statement. The stop order may be rescinded when the registration statement has been amended.

If a registration statement contains an untrue statement of a material fact, or if it omits a material fact required to be stated or necessary to make a fact as stated not misleading, the persons who signed the statement are liable. Any person who purchases a security without knowledge of the untruth or the omission may sue every person who signed the statement, every director in the corporation, every underwriter, and every accountant, engineer, or appraiser who has with his consent been named as having prepared or certified any statement. Such persons are held liable unless they can show that they had reasonable ground to believe that the statements which they made were true. The amount of the liability is limited to the amount at which the security was offered to the public.

The Securities and Exchange Commission does not pass upon the soundness of any security or its desirability as an investment. It merely attempts to secure a complete statement of material facts in order that the investor may have the information which he needs before purchasing stocks or bonds.

The principal criticisms of the Securities Act as a protection to the investor are as follows: First, it is alleged that the Act was seriously weakened by an amendment which provided that the care required of directors and others who certify to the statements of the corporation is that which would be exercised by a prudent man in the care of his own property. The original Act required the care of a person in a fiduciary capacity or trustee. A second criticism is that any legal action to hold directors or others responsible must be taken within three years after the issue of the securities. The original provision was ten years. A third criticism is that any person who brings suit may be required, at the discretion of the court, to furnish bond to guarantee the costs of the suit in case they should be assessed against the plaintiff. This, it is alleged, will prevent the suit of the average stockholder from being heard in court. Despite these limitations, however, it is generally agreed that the Securities Act has already accomplished much in protecting the stockholders' interests.

The stock exchanges and all securities traded on them are now subject to government supervision. Under the Securities Exchange Act of 1934, all exchanges are required to register with the Securities and Exchange Commission unless exempted because of the limited volume of transactions effected on any exchange.

An exchange, as a part of its registration, must agree to comply with the provisions of the Act, to discipline any member for conduct inconsistent with equitable principles of trading, and to furnish the Commission with data as to its organization, rules of procedure, and other information. The Commission may refuse to register an exchange if it finds that its rules and regulations are not adequate to insure fair dealing and to protect investors. This would mean that the exchange could not function since the members would be denied the use of the mails and other instrumentalities of interstate commerce.

Members of stock exchanges are not permitted to effect any transaction in a security on a national securities exchange unless a registration is effective for that security. The Act specifies that the application for registration for each security shall contain a copy of the corporate charter, by-laws, underwriting agreements, voting trust agreements, and certain other documents. It must also contain detailed information as to the organization, financial structure, and nature of the business of the corporation, the rights and privileges of each class of securities, the terms on which securities have been offered to the public during the three years preceding registration, bonus and profit-sharing agreements, management and service contracts, balance sheets, profit and loss statements, and certain other information which the Commission may deem appropriate for the protection of investors. The application for registration of a security is made by the issuer and not by the stock exchange.

The following provisions of the Act are especially significant:

1. Methods of trading on registered exchanges are regulated by the Commission. It is illegal to create a false appearance of activity in a stock, to place orders to buy and sell the stock at the same time, to circulate rumors that a stock is likely to rise or fall because of the activity of certain persons, or to circulate false or misleading statements with respect to any material fact which the person has any reasonable grounds for believing to be misleading.

2. Misleading as well as false statements of material fact subject a bond house, broker, dealer, and others to liability.

3. Any person who manipulates the price of a stock is liable in damages to anyone who buys at a price affected by the manipulation. This subjects the manipulator to possible heavy liability, for

he may have to indemnify an army of speculators for their losses.[3]

4. A broker is not allowed to extend credit to a customer without collateral. In buying securities for margin buyers or selling for short sellers, the broker must also comply with margin requirements fixed by the Federal Reserve Board.

5. A stockholder owning more than ten per cent of the stock of a corporation and any officer or director, regardless of how much stock he owns, who buys his corporation's own stock and sells it within six months is liable to the corporation for any profits made in such transactions. Profit made by selling the stock and buying it back within six months is likewise recoverable by the corporation. Suit to recover the profit may be instituted by either the corporation or any of its shareholders. To aid in the enforcement of this provision, the corporation is required to report regularly any changes in the stock ownership of officers, directors, and large stockholders.

Trading in unlisted securities is still permitted. The Securities Exchange Act of 1934 stipulated that the Securities and Exchange Commission might continue unlisted trading privileges to any security which had been admitted to such trading prior to March 1, 1934, without the filing of the usual registration statement. The Commission was directed to make a study of trading in unlisted securities and to report its findings to Congress. In its report dated January 3, 1936, the Commission stated its opinion that the privilege should be continued for an indefinite period because of the possible effect upon security prices if such trading should be discontinued. In May, 1936, the Securities Exchange Act was amended to permit the continuation of unlisted trading privileges, subject to the control of the Commission.

Sales in over-the-counter markets are now regulated. Over-the-counter markets are the facilities for purchase and sale of securities afforded by brokers who deal with buyers and sellers outside the stock exchange. Sales may be made by matching orders from buyers and sellers or by arranging trades with other brokers. These markets were brought under Federal control in 1938 when an amendment to the Securities Exchange Act of 1934,

[3] The largest claim which has been filed under this provision of the law was a suit by Robert R. Young against George A. Ball for $5,000,000 because of Mr. Ball's alleged manipulation of the preferred stock of the Allegheny Corporation. A settlement was made for $4,000,000. See Matthew Josephson: "The Daring Young Man of Wall Street," *Saturday Evening Post,* Vol. 218, pp. 35, 57, Aug. 25, 1945.

known as the Maloney Act, was passed. The law provides for a system of regulation through the formation of one or more voluntary associations of investment bankers, brokers, and dealers in securities, the associations to be formed under the supervision of the Securities and Exchange Commission. After conferences had been held between the Commission and the brokers or dealers, an association known as the National Association of Securities Dealers, Inc., was formed with membership open to all dealers except those who had disqualified themselves by their previous conduct. The members number about 3,000 single proprietorships, partnerships, and corporations dealing in securities. No other association has been formed under the provisions of the Act.

The N.A.S.D., as the association is popularly designated, seeks to raise the standards of business practice in the over-the-counter markets through the promulgation of rules of conduct and through educational work carried on both independently by its committees and jointly with the Commission. The Association may take disciplinary action against brokers who are guilty of unethical but not illegal conduct. Serious cases are referred to the Commission for action. The Commission also makes investigations; and when it finds minor violations of the rules of practice, it refers them to the Association. It handles the serious cases itself. The penalty for violation of rules of conduct may be a letter of censure, a fine of as much as several hundred or possibly a few thousand dollars, suspension of membership in the Association for a period of two weeks or a month, or revocation of membership. Expulsion is a serious penalty because it deprives a dealer of the right to use the mails or to engage in interstate commerce in securities.

The malpractices for which a member may be punished include making secret profits at the expense of the customer by misrepresenting to him the amount received for his security in case of a sale or the amount paid in the case of a purchase. A member cannot sell securities to customers at prices not reasonably related to the market. The pledging or hypothecation of the securities owned by a customer as security for a loan is an offense unless done in accordance with the rules of the Association. The rules require that the consent of the customer be obtained before his securities are pledged. Financial insolvency is also a reason for suspension or revocation of membership, since the public must be protected from trading through an insolvent firm. The making of misleading statements, the fraudulent omission of material facts in the sale of se-

curities, and abuse of a relationship of trust and confidence between a firm and its customers are other serious offenses. The over-the-counter markets are more difficult to regulate than are the stock exchanges where transactions are subject to a certain amount of scrutiny by other members of the exchange, but the tone of the markets has been much improved by regulation through the N.A.S.D. and the Commission.

Some persons contend that Federal regulation has caused fluctuations in security prices to become more violent. The argument is that informed buying and selling has been largely eliminated by the restrictions imposed by the Securities Exchange Act, since officers, directors, and large stockholders can no longer afford to buy and sell securities when the profit, if any, is recoverable by the corporation if less than six months elapse between purchase and sale, whereas the losses must be borne by the individuals. It is said that persons of wealth, who constitute the informed buyers, formerly bought when prices were too low and sold when they were too high, thus helping to stabilize market prices. Since their buying has been reduced in volume as a result of Federal regulation, the market has been placed under the influence of a mass of poorly informed security holders who are moved at one time by undue optimism and at another by unreasoned fear. However, this argument overlooks the fact that officers and directors may still purchase and sell the stocks of their corporation for their own profit provided a period of six months elapses between the purchase and sale, and they may speculate in the stocks of other corporations without any restriction.

A further criticism of the Act is that in time of threatened market decline, buying by large, informed financial interests is restricted in volume by the increased margin requirements. It must be remembered, however, that before the Federal legislation was enacted, speculation by the public was very often carried on with small margins—with resulting market excesses at one time and sharp declines at another.

The Securities Exchange Act represents a very important step in the protection of the interests of the small stockholder. The stockholder is entitled to information with respect to the financial condition of his corporation, provided its publication will not injure its interests. Moreover, a director or officer of a large company should regard his position as similar to that of a trustee. He should not use the knowledge gained from the corporation in furthering

his own interests to the detriment of either the stockholders or the corporation. Most directors and officers would not do so, and in the public interest the control of unscrupulous persons becomes both necessary and desirable.

Annual reports to stockholders have greatly improved since 1933. Prior to 1933, reports made by corporations to their stockholders were subject to serious criticism. A few corporations published detailed and adequate reports, but many issued brief, vague, and inadequate reports while some issued none at all. Some corporations supplied their stockholders with nothing more than a balance sheet while others published very meager income statements which showed only three or four items in addition to the final figure of net income. Many financial statements were of the leaflet type, printed on a single folded sheet of paper. W. Z. Ripley, writing in 1926, described some corporate reports as diminutive, dainty, tied with a fancy string, and reminiscent of the dance cards of youth, while others were emblazoned with gilt or colored reproductions of lighted factory buildings or one thing or another and about as satisfying to the stockholder as an advertising display of ham and eggs is to a hungry person.[4]

While neither the Securities Act of 1933 nor the Securities Exchange Act of 1934 requires annual reports for stockholders, the tendency is for corporations to render such reports and to make them conform in content if not in detail with statements filed with the Securities and Exchange Commission. Such reports usually contain balance sheets, income statements, and statements of surplus together with explanatory footnotes. Some corporations include a discussion of corporate financial affairs as disclosed in the statements. The statements are auditied by certified public accountants. Some reports to stockholders include comparative financial statements for two to five or even ten years. Significant developments affecting production or operating policies of the corporation are usually discussed. Many corporations supply their stockholders with semiannual financial statements, while other communications are mailed out from time to time informing stockholders of such developments as the results of litigation, the attitude of the corporation toward the removal of price regulations or other controls established during the war, and pending legislation which would affect the corporation. After the close of the Second World War in 1945, many corporations prepared statements for

[4] *Main Street and Wall Street,* p. 163.

stockholders describing their part in various phases of the war program which previously had been a military secret. This was true, for example, of corporations coöperating in the development of radar and the atomic bomb. Such statements are designed to foster stockholder and public goodwill.

Questions

1. Should the sale of highly speculative securities be permitted by the state? Do all newly organized businesses involve a substantial degree of risk?

2. How does the law distinguish a high-grade security from a highly speculative security?

3. How are people induced to buy securities offering no prospect of success?

4. What is the disclaimer clause? Does it appear on prospectuses to-day?

5. What are the four types of blue-sky laws?

6. Why have state securities laws not been more effective?

7. What are the limitations of the stock exchange in obtaining information for investors?

8. What types of information must be supplied the purchaser of securities in compliance with the Securities Act of 1933?

9. What are the limitations, if any, upon information supplied the purchaser in accordance with the Securities Act? An American corporation had extensive investments in rubber plantations in the East Indies in 1941 when the Japanese attacked. Of what value to the prospective investor would financial statements of such a corporation have been in 1941?

10. What control is now exercised by the Federal government over stock exchanges?

11. What is meant by trading in unlisted securities? Why is it still permitted?

12. What are over-the-counter markets? Why are they more difficult to regulate than the stock exchanges?

13. How are over-the-counter markets regulated?

14. How is securities information now made available to investors?

CHAPTER XII

The Directors

In the large corporation many corporate powers must be exercised by others besides the stockholders. The stockholders meet only once a year, and their control of corporate affairs cannot be of a detailed and continuous nature. The stockholders, even in legal theory, can do no more than determine the most general policies of the corporation; they must leave to others the important problems of administration and even many questions of policy. The directors, on the other hand, are a relatively small body, and it is their function to exercise a continuous supervision. They in turn find it necessary to appoint officers to direct the administration of the business of the corporation.

I. The Powers of Directors

The directors are entrusted with the actual immediate control of the property of the corporation. Since the title to the corporate property is vested in the corporation and not in the stockholders, it follows that the control of the property is vested in the corporation and its representatives. The board of directors, in addition to its responsibility for the control of the property, is charged with the adoption and execution of business plans and policies, subject to any restrictions which are contained in the charter and the by-laws.

The powers of the directors are inherent in their relation to the corporation. Legally the directors are not the agents of the corporation, but its representatives. When they make contracts or conduct any business, the corporation itself is acting. The directors can do anything which the corporation can do, whether by express or implied power.

Specifically, the powers which are usually exercised by the board of directors are as follows:

1. The election of officers.

2. The determining of corporate policies, subject to the provisions of the charter and the by-laws.

3. The making of contracts in the name of the corporation.

4. The declaration of dividends.

5. The issuing of corporate stock.

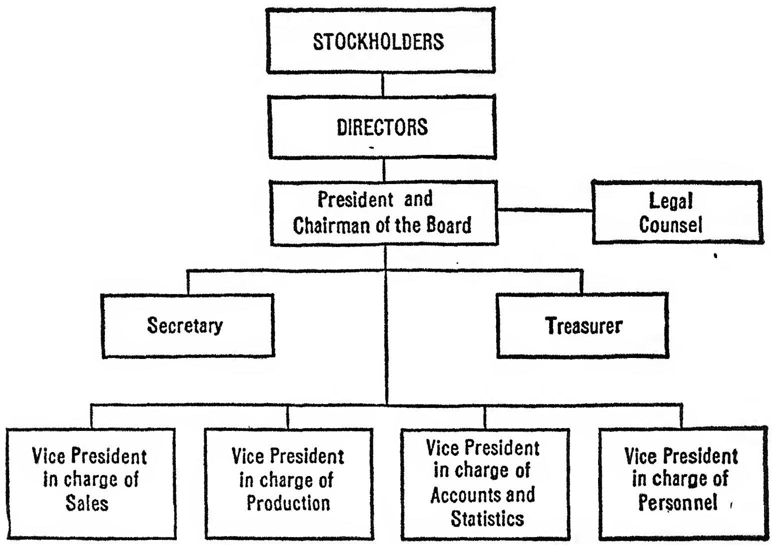
6. The exercise of any other powers conferred by the charter or by-laws.

The directors exercise their powers as a group, not individually. All decisions of the board are made at the meetings, and even though the required majority of the directors might individually approve a measure, this approval would not bind the corporation unless it is given by a vote of the board. The board of directors is a deliberative body, and its decisions should be reached only after a full discussion of all the facts in open meeting. It is for this reason that directors are not permitted to vote by proxy but must be present at the meeting and vote in person.

The directors elect the officers as provided by the by-laws. The officers usually provided for by the by-laws are the president, one or more vice-presidents, the treasurer, and the secretary. The president is the administrative head of the corporation and usually, though not necessarily, is chairman of the board of directors. The vice-presidents direct the important departments of the business; thus there may be a vice-president in charge of sales, another in charge of production, still another in charge of purchasing, and other vice-presidents according to the nature of the business. In some cases positions of lesser importance and responsibility are designated vice-presidencies in order to add to their dignity and to make them more attractive. The treasurer has charge of the receipt and disbursement of corporate funds and is required to render an account of all moneys received and disbursed; because of the close relation of finance to accounting, he is frequently placed in charge of both of those activities.

The secretary of the corporation keeps the minutes of all meetings of the board of directors and the stockholders; he has the custody of the corporate seal, issues stock certificates, keeps the record of stockholders and stock transfers, and sends out notices of meetings of the stockholders and of the directors. He prepares the corporate reports as required by law: these include the annual reports made to the state from which the charter

was received and to other states in which the corporation does business as a foreign corporation; and he also handles any correspondence with the secretary of state pertaining to applications for charter amendments. In addition to the officers named, there is sometimes special legal counsel. Other officers may be provided for by the by-laws as the nature of the business requires. The accompanying chart shows the typical organization of a corporation engaged in manufacturing.



The officers of a corporation frequently formulate policies for director approval. Legally the directors choose the officers to execute policies adopted by the board, but in practice the board may do no more than adopt, modify, or reject the policies recommended by the officers. This is frequently the case in the large corporation where the officers are better informed on corporate affairs than are the directors. In fact the officers may be directors and they may constitute a large percentage of the board. Moreover, officers who are also directors are more regular in their attendance at board meetings than other directors. In some corporations the officers dominate both meetings of the directors and meetings of stockholders with the result that they choose the directors instead of being chosen by them.[1]

[1] R. A. Gordon: *Leadership in the Large Corporation,* pp. 119, 145. Brookings Institution, Washington, 1945.

The directors decide many important questions of corporate policy. Although the stockholders must approve certain vital questions of policy, such as increasing the authorized capital stock or entering upon a new line of business activity, there are still many questions of policy which must be left to the directors. If the business operates under a budget system, the budget plans often are submitted by the president to the board of directors for its approval. In the adoption of the budget the directors must pass upon many important questions of policy. The budget carries appropriations for additions to plant and equipment, and it states in detail the financial plans of each department of the business. Plans for the expansion of the business through the purchase or erection of new plants are formulated and approved by the board of directors. Appropriations for the development of research in manufacturing or marketing must be made by the board. If the corporation has funds that are temporarily not needed in financing the business, the funds may be placed in special savings accounts or temporarily invested at the discretion of the board. The making of plans in time of war in preparation for conversion to peacetime production is entirely with the board of directors.

The decision to bring out a new bond issue usually rests with the directors. Many other policies, such as plans for sharing profits with employees, or bonus plans for executives, are first formulated and adopted by the directors and then submitted to the stockholders for their approval.

The directors make contracts in the name of the corporation. All important contracts of the corporation, as for the purchase of land, the erection of buildings or additions to buildings, or the purchase of patents, are made by the board of directors. The board of directors or the officers whom they appoint make contracts involving bills and notes, mortgages on the corporate property, purchases, sales, deeds, and all other general contracts of the corporation. They also prosecute and defend suits at law in the name of the corporation.

The directors authorize the payment of dividends. The payment of dividends to stockholders is made only after proper authorization by the board of directors. Even though all of the stockholders might agree to withdraw the profits from the business, they could not legally do so. The law is very strict on this point because once the money is legally withdrawn from the corporate treasury as dividends, it is beyond the reach of the creditors.

Dividends usually must be paid from income or earnings of the company. A dividend from capital, which is called a *liquidating dividend,* may be paid by a corporation at the time of its dissolution but only after creditors have been paid in full. A corporation whose principal business is mining or the development of some other natural resource subject to exhaustion may legally pay a liquidating dividend at any time in the amount of the value of the ore or other substance taken from the land. The corporation must inform the stockholders at the time of payment what part of the dividend is from income and what part is from capital.

The resolution declaring the dividend should indicate: (1) the rate or the amount per share; (2) the source of dividend, which would usually be income; (3) the class of stock entitled to the dividend; (4) the date payment is to be made and also the date of record for determining who is to receive it; and (5) the method of payment, as cash, property, or other method.

Dividends may be paid in any one of a number of forms The kinds of dividends are as follows:

- I. Dividends decreasing the equity of the stockholders.
  - A. Dividends paid from assets.
    1. Dividends paid in cash.
    2. Dividends paid in property.
  - B. Dividends paid in obligations of the paying corporation.
    1. Dividends paid in script.
    2. Dividends paid in bonds.
- II. Dividends not affecting the equity of stockholders.
  - A. Dividends paid in stock of the paying corporation.

Dividends are usually paid in cash but may be paid in any kind of property. Distilling companies have at times paid a dividend in liquor. Industrial corporations have on occasion paid government bonds as a property dividend. A corporation owning a substantial block of stock in another may distribute the stock of the second company as a dividend.

A *script dividend* is a dividend paid in promissory notes of the corporation, called script. They usually mature within a year from the date of issue. Sometimes they bear interest and sometimes they do not. Script dividends may be paid when the corporation has had earnings but has reinvested the profits in fixed properties or other assets and has no cash with which to pay the dividend. In such

cases the directors may declare a script dividend in order to give the stockholders tangible proof of the earnings of the corporation. Script dividends involve the corporation in the risk that it may not have ready cash when the script matures. Script is readily transferable and may be bought and sold on the stock exchanges.

Bond dividends are dividends payable in the bonds of the corporation which pays the dividends. They are seldom declared and paid, since they increase the fixed interest charges of the corporation and, in periods of decreased earnings, may cause the corporation to become involved in financial difficulties.

Stock dividends merely increase the outstanding stock and have no effect upon the equity of the stockholders in the corporation. They increase the number of shares outstanding but do not increase or decrease the property or liabilities of the company. Stock dividends frequently indicate that the directors contemplate an increase in the cash dividend disbursements, for if the corporation maintains the same rate of cash dividend after the stock dividend is declared as before, the total cash dividend payments will be larger.

It is sometimes assumed that stock dividends may legally be paid where other kinds of dividends cannot be paid. As a general rule, this is not true. In states where cash dividends can be paid only from earned surplus, stock dividends also can be paid only from earned surplus. If stock dividends can be paid from surplus created by funds paid in by the stockholders, that is, from capital surplus, then cash dividends can be paid from the same kind of surplus. A few states make a distinction, however. Thus, in Alabama a stock dividend may be paid from surplus created by writing up the book values of the properties of the corporation, provided the increased values of the assets have been established by an independent appraisal and the report of the appraisers under oath is entered in the minutes of the board of directors. No other dividend can be paid from surplus created in this manner.

A corporation may pay a small stock dividend each year in lieu of distributing current income as cash dividends. A corporation may also pay a small stock dividend each year along with a small cash dividend. Dividends of this kind require the distribution of fractional shares to those stockholders who hold an insufficient number of shares to entitle them to one whole share. Some corporations pay no dividends on fractional shares. In such cases stockholders may purchase sufficient fractional shares to round out

their holdings, sell their fractional shares, or forego dividends on such shares until later stock dividends increase their fractional holdings to full shares.

The directors are usually the sole judge of whether a dividend should be declared. Even though the corporation has had earnings out of which dividends might be paid, there is no necessity for the directors to declare a dividend unless they believe that it is in the best interests of the corporation to do so. The directors are usually the sole judge not only of whether a dividend shall be declared, but also of how much it shall be, if declared, and when and how it shall be paid. If the directors believe that the earnings should be reinvested in the business, they may decline to authorize the payment of a dividend. Such a decision is a matter of business judgment with which the courts ordinarily will not interfere.[2]

In exceptional cases the directors have been required to pay a dividend. This has happened when it appeared that the corporation had a large surplus and a large cash balance not greatly needed in the business. One reason the management might prefer not to pay a dividend under such circumstances is that it wishes to use the money for some philanthropic purpose from which the corporation would not necessarily benefit.[3] Another reason for failure to pay a dividend is that the directors might wish to induce certain shareholders to sell their stock to get cash. The board of directors cannot arbitrarily abuse its authority to pay dividends in such instances.

The directors usually may not revoke a dividend after its declaration has been made public. The dividend when declared becomes a debt against the corporation which may not be rescinded without the consent of the stockholder. There is a good reason for the prohibition of the revoking of a dividend in that such a power might enable the directors to work a fraud upon the stockholders who had placed them in a position of trust. While the earnings of a corporation are the most important factor in determining the price of a stock in the market, the news of the declaration of a dividend is not without its effect upon the price of the stock. If

[2] "In the matter of making or withholding dividends, the directors of a corporation are vested by law with a considerable discretion, uncontrollable by the courts unless the powers have been illegally or unconscientiously executed; or unless it be made to appear that the acts were fraudulent or collusive, and destructive of the rights of shareholders." (Ochs *v.* Maydole Hammer Co., 246 N.Y. Supp. 539 (1930).) See also Schmitt *v.* Eagle Roller Mill Co., 272 N.W. 277 (Minn., 1937).

[3] Dodge *et al.* *v.* Ford Motor Company, 204 Mich. 459 (1919).

the board of directors could announce a dividend and then revoke it at will, they might be able to manipulate the price of the stock to the profit of themselves and their friends but at the expense of the other stockholders.

Under some circumstances the board of directors may legally revoke a dividend after it has been declared. Any of the following might justify revocation:

1. The declaration has not been made public and no funds have been set aside for the purpose of payment.

2. The dividend has been illegally declared because the corporation has no earnings or profits available for dividends.

3. After the dividend was declared, some event changed the financial or cash position of the company, making the payment unwise from the point of view of the corporation. Such an event might be the declaration of war, the destruction of uninsured property of the corporation by fire or tornado, and the loss of a damage suit or other suit at law.

4. Failure to procure an amendment to the charter authorizing an additional issue of stock, in the case of a stock dividend.

The directors decide upon what terms the stock and bonds of the corporation shall be issued. Since the corporation needs additional funds from time to time, it may reinvest all or a part of the earnings, and it may bring out additional issues of stocks or bonds, subject to any limitations in the charter. The authorized capital stock is stated in the charter, but this may be increased by charter amendment. When additional stock is offered to the stockholders, the directors decide upon the time, the amount, and the terms of issue. The stock may be paid for partly in cash and the balance upon call of the board of directors. Stock is often issued in exchange for services or property, and the terms of such issue are determined by the board.

Stock "split-ups" and "split-downs" are made upon the recommendation of the directors and the approval of the stockholders. A stock split-up is an increase in the number of shares outstanding and is accomplished either by the reduction of the par value, say from $100 per share to $25 per share, or by a change from par value to no-par value stock, or the reverse. Stock split-ups are common in periods of prosperity and rising stock prices. The purpose of the split-up is usually to reduce the price of the stock in

the market and to reduce the number of dollars of dividends per share. The split-up must be distinguished from the stock dividend, which is paid from earnings and requires the transfer of a part of the surplus of the corporation to the capital-stock account. The split-up has no reference to earnings, being merely a change in the number of shares by which the capital is represented.

A stock split-down is a decrease in the number of shares outstanding. It is accomplished by increasing the par value of the stock, or by decreasing the number of shares but retaining the same par value, or by changing from par value to no par value. The method adopted depends upon the purpose of the board of directors. A change from a par value of $25 to a par value of $100 has the effect of increasing the price of the stock in the market in the ratio of 1:4. This is believed to help the credit of the company if its stock has been selling at, say, $10 or less. Investors are believed to prefer to buy stocks with somewhat higher market value. If the price of a stock has declined until it is less than $10, the psychological effect upon both creditors and investors is considered undesirable.

If the old par value is retained while the number of shares is reduced, the corporation may remove a deficit from the books and strengthen its position for paying dividends. A part of the original capital is used to offset the loss resulting from operations, and future profits may be used for dividends without regard to past losses. This same purpose may be accomplished by a reduction in the par value of the stock without a reduction in the number of shares.

The charter or by-laws may confer additional powers upon the board of directors. Additional powers include instituting legal suits in behalf of the corporation and employing counsel in prosecuting the case. The directors may also defend the corporation in suits brought against it and they may settle or compromise any such claims. They may not give away corporate property, though they can make donations, as to a community chest, if they believe that the corporation will benefit from the goodwill thus created. As noted in the preceding chapter, the directors are sometimes also given the power to issue additional stock without first offering it to stockholders. The powers of the directors, in any case, are very large. Any additional powers given them should clearly be in the interest of the corporation.

The directors may delegate some of their powers to committees.

The directors are not required to exercise all powers as a board but may authorize others to act for them. Usually one or more committees are organized and clothed with some of the powers of the board. The most common are an executive committee and a finance committee, but other committees may deal with salaries, bonus and profit-sharing plans, audit of the financial records of the corporation, and other phases of management. The exact authority of a committee depends upon the wording of the resolution of the board creating it. Sometimes the committee is empowered to make contracts in the name of the board, and sometimes it is required to report back to the board any recommendation it wishes to make, the final action then being taken by the board. In no case would a committee be empowered to make radical changes in the policy of the corporation or embark upon new extensions of the business. The committee serves principally to decide minor questions of business administration that cannot conveniently be held over until the regular meeting of the directors. In some cases committees formulate new policies and work out detailed plans which are submitted to the board for its approval before being carried out.

The directors have the right to essential information about the affairs of the corporation. Since the directors have important powers and duties in the management of the corporation, they are entitled to whatever information is necessary to enable them to reach decisions on questions of corporate management and corporate policy. They have the right to inspect the records and the property of the corporation and to familiarize themselves with the details of its operation. Directors are entitled to notice of all meetings, though if regular meetings are definitely scheduled they have no legal right to additional notice. Any director may attend the meetings of special committees of the board if he so desires. If a director finds anything wrong, he cannot correct it himself but must bring the matter to the attention of the board.

The powers of the directors may be expressly limited by the charter. A limitation upon the powers of the directors which is frequently found is that the corporate debt cannot be increased beyond a certain amount or that it cannot exceed a certain percentage of the capital stock outstanding. Some increases in debt, such as taxes, salaries, and interest, are not subject to the control of the directors, and the directors cannot be held responsible if the increase in liabilities is unavoidable. Another limitation upon the powers of the board of directors may be in the salaries of officers

that it is authorized to pay. The directors are in every case subject to limitations contained in the state incorporating law, and they can take no action which requires an amendment to the charter without first procuring the approval of the stockholders and the secretary of state.

II. The Liabilities of Directors

The directors are personally liable for an abuse of their powers. They are placed in a position of trust in the management of the property of the corporation, and they must place their duties to it above any financial or business obligations. The care that is required of them is that which a reasonably prudent man would take of his own property. They must also act with reasonable intelligence, though they cannot be held responsible for errors of judgment or lack of caution. An individual director is not responsible for the wrongful conduct of others. Therefore a director who is present at any meeting at which action constituting a breach of trust or any other illegal action is taken should make his objection known and see that his objection is recorded in the minutes. Specifically, some of the acts for which the directors may be personally liable are as follows:

1. *The declaration of illegal dividends.* No dividend can be declared which impairs the capital of the corporation. Directors, who approve the payment of a dividend when the corporation is insolvent or the payment of the dividend renders it insolvent, are jointly and severally liable to the corporation for losses to creditors as a result of the payment of the dividend. In determining the profits of the corporation, provision must be made for depreciation of fixed properties. It is not necessary for a corporation organized to develop wasting assets, such as mines or oil lands, to make provision for depletion of such assets, though the stockholders should be notified of the amount of the dividend which came from profits and the amount paid from capital.

2. *Fraudulent transfers of property.* Directors are liable for the transfer of property to stockholders or others for the purpose of defrauding creditors or for the conversion of corporate property to their own use.

3. *The lending of corporate money to directors or stockholders.*

4. *The making of false financial statements.* The Securities

Act of 1933 makes directors liable for any misstatement of a material fact in connection with the sale of securities, unless they had reasonable ground for belief that their statements were true.

5. *Illegal acts of the corporation done with their knowledge and consent.* If, for example, the statute provides that the corporation must not create debts beyond its subscribed capital stock, directors are personally liable to creditors in case they approve the contracting of such debts and the assets of the corporation are insufficient to pay them.

6. *General gross mismanagement.* What constitutes gross mismanagement depends upon the circumstances and also the type of business, such as investment company, bank, or chain store. In any case directors are expected to attend meetings of the board.

7. *Manipulation of the price of the stock of the corporation.* The directors, who are placed in a position of trust, have a marked advantage over other stockholders in buying and selling the stock of the corporation. A director cannot be expected to refrain from buying and selling stock during his term as director, but speculation in the stock of the company by a director is open to serious possibilities of abuse. Directors have been known to speculate in the stock of their corporation and, after the market price begins to fall, to use the corporate funds to support the market by authorizing the corporation to buy back its own stock. In other cases they pay dividends on the stock to create a belief that the corporation is in sound financial condition, when in fact the funds of the corporation should be held in the treasury or used for other purposes.

As pointed out in the preceding chapter, an officer or director who makes a profit from buying and selling the stock of his corporation may be compelled under the Securities Exchange Act of 1934 to pay the profit to the corporation, provided not more than six months elapse between the purchase and the sale. At the time of their election, directors are required to file a statement with both the stock exchange and the Securities and Exchange Commission indicating the number of shares they own. Thereafter if there is any change in the stockholdings of any director, he is required to file a monthly statement indicating what the changes are. A similar provision was included in the Public Utility Act of 1935.

8. *Selling property to the corporation at an excessive valuation.* Directors who wish to sell property or to make contracts with the corporation ordinarily are not permitted to vote on the contracts.

If the directors do make contracts with the corporation and the creditors or stockholders suffer a loss as a result, the directors may be personally liable. The directors may also be liable if they lease corporate property at a nominal rental with the understanding that they will personally share in the profits from the property, or if without due notice they foreclose on mortgages on property of the corporation which they hold, taking possession of collateral pledged as security.[4]

9. *Gross overvaluation of assets.* This liability exists only in gross overvaluation, not in ordinary overvaluation. Some states provide by statute that in the absence of fraud in the transaction the judgment of the directors as to the value of property received in exchange for stock shall be conclusive. The directors are further protected from liability in most states by the provision that stock may be issued for labor or services rendered; and Montana provides that in the acquiring of mine property any arbitrary valuation may be fixed and that such value shall be deemed to be the actual value of the mine. In most cases the directors must make an honest attempt at a fair valuation, and any conscious overvaluation is a fraud upon the other stockholders and the creditors. Because of the hesitancy of the courts to place a valuation upon property, this liability is often more theoretical than real.

10. *Violating the fiduciary relation of the director to the corporation and the shareholders.* For example, if a director abdicates his duties in favor of an incapable and irresponsible person, he may be held liable in damages. The director is also under duty not to acquire for himself property which is potentially profitable to the corporation, if he has obtained knowledge of its value through his official position, or if he has induced the corporation to refrain from purchasing, or if the property is peculiarly necessary for the corporation.[5] Directors are in a fiduciary relation also toward individual shareholders with respect to their shares and may not deal with shareholders without disclosing all the information affecting the value of the stock which their official position has given them.[6]

11. *Additional liability under certain statutes.* Under the Clay-

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[4] "Corporations—Representative Suits," *Minnesota Law Review,* April, 1937, Vol. 21, p. 596.

[5] "Clash of Personal and Corporate Interest as Affecting Business Activities of Officers and Directors," *University of Pennsylvania Law Review,* June, 1936, Vol. 84, pp. 1008-1018.

[6] Dunnett *et al. v.* Arn, 91 Fed. (2d) 912 (1934).

ton Act of 1914 a violation of the antitrust laws is considered the act of individual directors, officers, or agents who authorized the violation. Punishment is a fine not exceeding $5,000 or imprisonment not exceeding one year, or both, in the discretion of the court.

III. Organization of the Board of Directors

Boards of directors differ widely in their organization. Some are organized to assume active supervision of corporate affairs while others are loosely organized and leave most of the policy formation to officers. One reason for variations in organization is that state laws differ, but a more important reason is the ability of some members to inspire confidence in their leadership.

There are few legal qualifications for directors. Despite the fact that the directors exercise great powers in the management of corporate property, their legal qualifications are few and unimportant. It is usually required that the director own at least one share of stock, but in some states he need not own any, and in no state is he required to have a substantial interest in the corporation. The requirement that a director must own one share of stock is often met by setting up what are known as "dummy" directors. A share of stock is assigned to an employee in the office of an attorney or incorporating company, who assigns the interest back to the real owner; thus, the employee, being registered on the books of the corporation as the owner of one share, is qualified to serve as a director. Where there is a conflict between two groups in the corporation, dummy directors have cast a deciding vote.

Another common statutory requirement is that one or more directors must reside in the state of incorporation. Some states require that at least one director must be a citizen of the United States. These requirements are only nominal. Moreover, they are easily evaded by the use of dummy directors.

A minimum number of directors is usually required by law. The statutes usually prescribe the minimum number of directors, but some prescribe both the maximum and the minimum number, and many states permit any number. The number of directors is, in fact, determined by business requirements rather than by legal requirements. It is desirable to have a large enough number to permit various groups of stockholders to have representation, and to permit bankers and other men with special business training and experience to hold positions on the board. If the corporation pro-

cures the election of some well-known persons on the board purely for advertising purposes, the number of directors must be large enough for this and, at the same time, include other directors to perform the true functions of the board. The usual number is ten to fifteen. Small corporations may have as few as three. An odd number is desirable to prevent a tie vote.

The term of office is usually one year. Most corporations re-elect the entire number of directors each year at the stockholders' meeting. Some have a longer term, with a part of the board retiring each year. A common arrangement is for a term of three years, the term of one-third of the board expiring each year. The latter plan has the advantage of giving the corporation stability of policy. The stockholders may remove any director at any regular or special meeting called for the purpose. In some states the directors may be removed only for cause, while in other states they may be removed at will by the stockholders.

The compensation of directors is usually provided in the by-laws. Directors are not entitled to compensation unless it is specifically provided, but such provision is usually made in the by-laws. The directors do not receive a salary but are allowed a fee for each meeting which they attend. In small corporations in which the stock is closely held and in which the directors are also officers, the directors often serve without compensation.

Each corporation whose stock is traded on registered exchanges is required under the Securities Exchange Act of 1934 to furnish the Securities and Exchange Commission with information in respect to the remuneration of officers and directors. It must also report remuneration paid to others, if more than $20,000 per annum, any bonus and profit-sharing arrangements, and any management and service contracts of the corporation.

Special provision is sometimes made to insure the minority stockholder one or more representatives on the board. There are two provisions which may be made in the charter to assure minority representation: (1) cumulative voting, and (2) classification of stock. Cumulative voting is much the more common provision. This is a method of voting at stockholders' meetings which permits the stockholder to cumulate or concentrate his votes on one or more candidates as he chooses. For example, if there are five directors to be elected, the stockholder may cast all five of his votes for one person, or he may divide his votes between two or more persons. If there are 600 voting shares outstanding, and five directors are to

be elected, the total votes to be cast is 3,000. The possession of the voting rights of 101 shares will insure the election of one director. The candidate of the minority will receive 505 votes, while the five candidates of the majority will each receive 499 votes. Without the advantage of cumulative voting, five minority candidates would receive 101 votes each while the five majority candidates would receive 499 votes each, and all majority candidates would be elected.

The number of shares necessary to elect a desired number of directors under a plan of cumulative voting may be computed in the following manner: multiply the total number of shares outstanding by the number of directors which the minority desires to elect; divide this figure by the total number of directors to be elected plus one; to the quotient add one, and the result is the minimum number of shares required.[7] The formula may be stated as follows:

$$\text{Minimum number of shares} = 1 + \frac{\begin{array}{c}\text{Total shares}\\ \text{outstanding}\end{array} \times \begin{array}{c}\text{Number of directors}\\ \text{minority wishes to elect}\end{array}}{1 + \text{Total number of directors to be elected}}$$

There is a decided advantage to the minority in having a representative on the board. If the majority honestly desires to manage the corporation fairly in the interests of all, it will heed the suggestions and criticisms of the minority and possibly modify its actions. If the majority does not wish to act in the best interests of the corporation, the representative of the minority can speak at the meetings and he can report to the stockholders concerning actions taken. If the minority knows what decisions are made by the board, it can do much to protect its interests.

The principal danger of cumulative voting is that a well-organized and aggressive minority of stockholders may be able to elect a majority of the board, if the majority stockholders are not organized and scatter their votes. If there are five directors to be elected and the majority stockholders vote for five candidates, a minority, by concentrating their votes, might be able to elect three directors. For this reason cumulative voting is not permitted in some states.

Different groups of stockholders may be assured representation on the board of directors through the classification of stock. The stock may be classified into Class A common stock and Class B common stock, each class being given the right to elect a certain number of directors. In the same way the preferred stockholders may be empowered to elect a certain number of representatives to

[7] See C. W. Gerstenberg: "Mathematics of Cumulative Voting," *Journal of Accountancy,* Jan., 1910.

the board. The device of stock classification has also been used to disfranchise large groups of stockholders, for the preferred stock and some classes of common stock often have no voting rights.

Most states permit meetings of the directors to be held outside the state of incorporation. The most common statutory provision for directors' meetings is that the meetings may be held within or without the state. A few states provide that meetings may be held outside the state if the charter or by-laws so provide, while Idaho and Louisiana permit the directors to select the place of meeting, which may be either within or without the state. A corporation receiving its charter in the District of Columbia must hold its directors' meetings within the District. Some states make no specific provision for the place of the directors' meeting, but in such cases it is generally held that provision may be made by a clause in the charter or the by-laws.

At the first meeting of the directors the organization of the corporation is completed. The first meeting of the directors is called by the directors themselves, some one director usually taking the initiative. There is as yet no secretary of the corporation to send out formal notices, as is done for the later meetings. The directors may jointly sign the notice of the meeting and waive the right to any formal notice. This is a mere legal technicality to assure that the meeting is properly assembled.

The first meeting of the directors, like the first meeting of the stockholders, is usually a very formal proceeding. The terms upon which the corporation is to be formed and the lines upon which it is to be organized have already been agreed upon in advance, and the agreements are merely confirmed by the directors at their meeting. The principal business transacted at the first meeting is as follows:

1. *The election of officers.* The by-laws, which provide what officers are to be elected, have already been adopted by the stockholders, and usually there has been agreement in advance as to who the officers shall be. The officers begin their duties as soon as elected, and the president and secretary act through the remainder of the meeting.

2. *The adoption of the stock certificates.* This also has been agreed upon in advance, but the form of the stock certificate must be approved by the directors to make it legal.

3. *Confirmation of contracts for the purchase of property.* Most

corporations are formed by businesses already organized that wish to change from a partnership to a corporation, or that wish to be combined with other businesses to form a new corporation. When this is the case, the new corporation takes over the property of the partnership or the old corporation in exchange for its own stock at agreed valuations.

4. *Miscellaneous business,* having to do with various contracts for property and service and other details necessary for the corporation to begin business operations.

The business of the corporation is attended to at regular or special meetings of the board. The board usually has a regular time of meeting, which may be once a month or less frequently. Special meetings may be called as the necessities of business require. At these meetings the directors perform the duties and exercise the powers discussed in the preceding paragraphs. These meetings are not formal, with a cut-and-dried procedure, but represent the actual functioning of the corporation.

The wide diffusion of stock ownership has greatly changed the relation of the directors to the corporation. First, the diffusion of stock has resulted in the directors having only a relatively small stake in the enterprise which they control. The requirement of stock ownership, even when it exists, is only nominal and does not insure that the directors are vitally interested in seeing the corporation prosper. On the contrary, in some corporations the directors have approved contracts from which they personally have profited and which apparently were not in the best interests of the corporation.[8] However, directors usually serve in order to protect their investments in the corporation.[9] Second, the small stockholder is often unable to know what his directors are doing. The minutes of the board of directors are not open to the stockholders, and this often gives the directors a free hand to do as they please, sometimes to the neglect of the best interests of the corporation. Third, the average small stockholder knows nothing about the business. Even if he has the facts pertaining to salary and other contracts entered into by the board, he cannot always judge intelligently whether the board is acting in the best interests of the corporation. The great-

[8] See John T. Flynn: *Graft in Business,* Vanguard Press, New York, 1931. Also John T. Flynn: *Security Speculation,* Harcourt, Brace and Co., New York, 1934.

[9] R. A. Gordon: *Leadership in the Large Corporation,* p. 315. Brookings Institution, Washington, 1945.

est danger of the modern large corporation is that it may be made to serve the interests of the few who control it.

Checks against the abuse of corporate power by the directors are gradually developing. The first such check arises from the need of new capital; a corporation that has betrayed the interests of its stockholders may find that it is unable to raise additional capital from the public through the sale of stocks and bonds. But this check is quite ineffective to prevent the wrecking of the corporation, since it may amount to no more than an attempt to lock the stable door after the horse has disappeared. Second, financial standards are gradually developing; as investors learn more about financial statements and methods of judging the soundness of their corporation, they will be better able to determine whether officers and directors are rendering a good account of their trust. Third, state and Federal control of public enterprises is becoming more effective. The Securities Act of 1933 is a significant step in the control of the issue of new securities. Other measures include Federal regulation of public utility financing and of corporate receiverships and reorganizations. The extension of Federal lending activities since 1940 has also increased the voice of the government in corporate affairs. Fourth, the holding of directors liable for an abuse of their powers promises to be effective. Finally, it should be said that in most large corporations, there are a few large stockholders who are sufficiently interested to raise a protest if the affairs of the corporation are mismanaged, and these stockholders frequently serve as directors. The revision of methods of soliciting proxies as a result of regulation under the Securities Exchange Act of 1934 gives these stockholders increased influence in corporate affairs. The fact that large stockholders will protest abuses is a strong deterrent to those who would act contrary to the interests of the corporation.

Questions

1. What is meant by the statement that a corporation made a contract for the purchase of property? Since the corporation is not a real person, how can it take any action?
2. The president of a corporation calls each director by telephone and obtains his consent for the declaration and payment of a dividend on the stock. Is the dividend legal? Why?
3. How can it be said that the officers choose the directors?
4. What powers are usually vested in the board of directors?

5. Draft a resolution for the declaration of a dividend to be presented at a meeting of the board.

6. Name the kinds of dividends and indicate the circumstances under which each might be declared.

7. Why should the directors not be permitted to revoke a dividend after it has been announced? Under what circumstances may they do so?

8. What is a stock split-up? What is a stock split-down? What is the purpose of each?

9. Can a stock split-up be effected by a reduction in the par value of the stock? By a change from par to no par value stock? By a change from no par value to par value stock?

10. What information should be supplied to corporate directors?

11. Are directors always entitled to fees for attending meetings or must provision be made in the charter or by-laws? How does their position compare with that of trustees in a business trust?

12. A person agrees to serve as director but fails to attend meetings or to keep himself informed concerning corporate affairs. Does he have any liability?

13. A director is present when a dividend is declared with no profits from which to make the payment. What should the director do to protect himself from liability?

14. What is gross mismanagement?

15. Is it desirable for a director to own a large number of shares of stock? Why do many states not require the ownership of stock as a requirement for membership on the board?

16. How does cumulative voting help the minority to elect a member to the board? Why do some states not permit cumulative voting?

17. At a meeting of stockholders, five directors are to be elected. The total number of shares represented at the meeting is 300,000. How many shares would be necessary to assure the election of one director? How many shares would be necessary to assure the election of two directors? Show how a well-organized minority might elect a majority of the board.

18. What legislation has been enacted to protect minority stockholders against mismanagement of corporations?

19. What is the advantage to a group of minority stockholders in having one member on the board? Would he not be outvoted an all propositions?

CHAPTER XIII

Corporate Dissolution and Reorganization

Although the charter may authorize the corporation to operate in perpetuity, the corporate life is not necessarily perpetual. In some cases the corporation finds it necessary to discontinue operations because of financial difficulties or other complications. In other cases the corporation may be able to continue its business activities by reorganizing its capitalization through a reduction of the amount of its outstanding securities or a modification of their claims upon the corporation, such as a reduction in interest or preferred stock dividend rates. Corrective measures depend upon the cause and the seriousness of the difficulties of the corporation.

I. Corporate Failure

The causes of corporate failure are numerous. Some of the usual causes of the failure of small enterprises were considered in Chapter II, and many of the same difficulties are encountered by large enterprises. Some of the causes are peculiar to manufacturing, public utility, railway, or other businesses and also to the corporate form of organization with its capital structure of bonds, preferred stock, and common stock.

Some causes of corporate failure are incident to the formation and launching of the enterprise. The organizers of a new enterprise may misjudge the probable demand for the product or services to be sold, underestimate the costs of production, or overestimate the price at which the products can be sold. After operations are begun, demand may not expand as rapidly as anticipated, with the result that the corporation has an unused plant capacity and heavy unutilized overhead expense, which result in operating losses. If excessive amounts of securities were issued at the time of organization, either for properties at an overvaluation or to promoters, investment bankers, or officers for their services, the corporation may be unable to carry the charges for the depreciation of properties or the amortization of the cost of other assets such as

patents. If the securities issued in exchange for the properties or services were interest-bearing, the corporation would have the added burden of interest payments. Poor location of plant, the purchase of obsolete buildings and equipment, poor selection and arrangement of productive facilities, the payment of excessive sums in cash for properties, or the contracting to pay high rental charges are added causes of difficulty. An underestimate of the amount of capital required may result in a lack of working capital and an inability to meet liabilities as they mature.

Many problems arise in connection with expansion. Too rapid expansion may result in an inefficient or an overextended plant and administrative organization, the addition of lines of product that do not pay their way, and an attempt to develop territories that are unprofitable. As additional activities are undertaken, the management may be confronted with problems of production or marketing with which it is unable to cope. The officers may be unable to deal competently with such problems as the delegation of authority to managers at distant locations. Many businesses which were successful on a small scale are not successful when they attempt to expand the scope of their activities.

An established business may become unprofitable as a result of its inability to meet changes in the market. New commodities such as rayon, nylon, synthetic rubber, magnesium, radios, and plastics create difficult problems of adjustment for manufacturers who formerly made the products being replaced. New sources of supply cause a decreased demand for the products of existing firms, and a reduction in the prices charged by the new producers may require radical changes in the policies of firms which formerly supplied the market. For example, the increased lending activities of the Federal government have greatly increased the supply of funds and decreased interest rates, thereby creating serious problems for commercial banks, savings institutions, insurance companies, building and loan associations, and other institutions. New methods of production, such as the substitution of welding for riveting, require far-reaching changes in industry. The rise of department stores resulted in revolutionary changes in retail distribution, but department stores in turn have been required to adapt their policies to meet the competition of mail-order houses and chain stores in such lines as shoes, dresses, millinery, and notions.

Many businesses launched in periods of prosperity are unable to meet the difficulties which arise in the ensuing depression. Hard

times bring a decreased volume of sales, increased bad debt losses, and falling inventory prices. A slower realization of inventories and accounts receivable may result in an inability to meet maturing liabilities. Some businesses appear prosperous until the time of inventory taking, when it is learned that asset values have been lost. Sometimes a business may seem to be making profits until important units of fixed properties are to be scrapped or replaced, when it is discovered that the company has made inadequate provision for depreciation, overstated its profits, paid unwarranted dividends, and impaired its capital.

Many isolated and accidental causes may result in failure. Most accidental losses may be anticipated and provided for through insurance, but adequate provision is not always made. The causes include such hazards as fire, explosion of boilers or heating equipment, sabotage, windstorm, tornado, tidal wave, collapse of building because of snow and ice, riot and civil commotion, embezzlement, failure of one or a few customers owing large amounts, and possibly the failure of an insurance company with which properties have been insured. The death of a key man in the organization may also have serious effects upon the profits of an enterprise. Most of the disasters named cause losses of property, but some of them such as an explosion or the collapse of a building under weight of ice may cause liability to others. Fires and other catastrophes may result in a disruption of business and a loss of profits in addition to the loss of property.

There are many gradations of business failure. Business failure may mean only that the enterprise can pay no dividends or is unable to pay a satisfactory rate of dividends on its stock. In such a case, failure does not mean that the company is unable to pay its debts, but only that it cannot earn the anticipated rate of return on the capital invested in the enterprise. This situation constitutes failure because the business is less profitable than the organizers had anticipated it would be. The enterprise may continue to operate as long as it keeps its debts paid and makes enough to cover its expenses. The stocks of such companies, known in the market as "cats and dogs," have a speculative value so long as there is a possibility that an issuer can pay dividends at some future time. Such an enterprise will not be dissolved if it can keep its debts paid as they mature and perhaps earn a fair rate of return on what would be realized from the sale of the equipment and other assets as scrap. The losses may be no more if operations are continued than they would be if the business were to be closed out, and there is always

the possibility that conditions may improve. Some unprofitable companies are continued because the managers do not wish to give up their positions and their salaries. Their control of the machinery for the election of directors enables them to keep the company in operation long after it should have been dissolved.

If a company has issued preferred as well as common stock, its failure may be reflected in its inability to pay the preferred dividends. Such a situation would not result in bankruptcy because the preferred dividends may be passed for an indefinite period without causing the corporation to become insolvent. However, as a result of a charter provision, the preferred stockholders may acquire the right to vote for directors, and the common stockholders may be deprived of any such right until all back dividends have been paid. The preferred stockholders might not be able to correct the difficulties of the corporation, and a reorganization of the capital structure may be necessary in order to prevent the continued accumulation of back dividends on the preferred stock.

A more serious situation would arise if the corporation is unable to pay interest on its bonds or to meet its liabilities as they mature. Inability to pay corporate debts might mean that the corporation is insolvent, that is, that the liabilities exceed the assets at a fair valuation, or it might mean only that the assets were temporarily frozen and therefore unavailable in liquid form.

The greatest difficulty arises if the gross income of the corporation is less than the costs of production and the operating and financial expenses. A possible solution would be to scale down the depreciation charges by writing down the book value of the fixed properties. This would decrease the expenses but not the cash demands upon the business. Interest charges may be reduced by agreement with creditors. If the income cannot be made to equal the costs of production plus the operating and financial expenses exclusive of depreciation and interest, dissolution is inevitable unless the situation is temporary and shows promise of early improvement. A corporation can draw upon its surplus and its capital to meet operating losses for a short time, but it cannot continue to do so for an indefinite period.

II. Dissolution of Corporate Business

Corporate financial difficulties may be corrected by any one of several remedies depending upon how serious the situation is. The sale of unprofitable branches, the dropping of unprofitable sub-

sidiaries through a sale of their stock, a change in the management, or a change in corporate production methods or policies may be sufficient to correct an unfavorable trend. If a more radical remedy is necessary, the depreciation charges may be reduced by writing down the values of fixed properties. The dividend rights of preferred stockholders or the claims of creditors for interest or for a repayment of the principal of their loans may be modified. If the difficulties of the corporation are too serious to be corrected by reorganization, the business may be terminated through consolidation with another corporation, or through the sale of the assets for what they will bring. Although the dissolution of a business is the more radical procedure, it is somewhat less complicated and therefore will be discussed first.[1]

A corporation which is unable to earn a satisfactory profit may be dissolved by vote of the shareholders. A corporation may be dissolved even though it is solvent, when its purpose has been fulfilled or when the prospects for profit appear hopeless. The procedure to be followed in dissolution is prescribed by the law of the state which granted the charter. Usually the directors pass a resolution recommending the dissolution, and the stockholders are asked to approve it at a regular or special meeting. More than a mere majority of the stock is required to adopt such a resolution, the usual majority being three-fourths. The assets may then be sold, the liabilities paid, and the balance distributed among the shareholders according to the rights of each class of stock.

A company which is unable to pay its debts may allow creditors to take over its properties by foreclosure. The corporation may have borrowed money through notes secured by mortgages on its properties including motor trucks, fixtures, and merchandise inventory, or even by the assignment of its accounts due from customers. In the event of default in the payment of principal or interest, creditors may foreclose on their mortgages or other liens and take over the property in settlement of their claims. This procedure would be wasteful in most cases, however, since a disorderly realization of assets would cause property values to melt away. The scramble of creditors to attach properties would result in inequities

[1] The following readings on corporate bankruptcy and reorganization are recommended: L. S. Lyon, M. W. Watkins, and Victor Abramson: *Government and Economic Life,* Vol. I, pp. 81-115. Brookings Institution, Washington, 1939. Norman S. Buchanan: *The Economics of Corporate Enterprise,* pp. 390-441. Henry Holt and Co., New York, 1940. Harry G. Guthman and Herbert E. Dougall: *Corporate Financial Policy,* pp. 649-721. Prentice-Hall, Inc., New York, 1940.

in the settlement of various conflicting claims. Orderly realization of assets over a period of time and the liquidation of liabilities after all creditors have been allowed to present and prove their claims is usually better for both debtor and creditors.

The debtor company may assign its properties to a trustee for the benefit of creditors. To assure that all creditors are fairly treated, the debtor company may assign its properties to a trustee who is authorized to sell the assets and to use the proceeds for the liquidation of the liabilities on an equitable basis. Each creditor must present and prove his claim; and if he fails to present his claim, he can reach only the assets which are left after others have been paid. The weakness of this method is that an assignment for the benefit of creditors does not relieve the debtor of liability for unliquidated claims. Any creditor having an unpaid balance due him can levy upon properties later acquired by the debtor corporation.

The debtor corporation may be declared a bankrupt in accordance with the laws of bankruptcy. Bankruptcy is regulated by the states and also by Congress. Authority of the Federal law arises from the diversity of citizenship of the parties in the case. The present law was enacted in 1898, with later amendments. Under the Federal law, bankruptcy may be voluntary or involuntary. Some institutions cannot become voluntary bankrupts. These are railroad and banking corporations and building and loan associations. This means that these institutions cannot take the initiative to get their cases into court but must wait to be sued by a creditor. However, this is easily accomplished through the offices of a "friendly creditor." If a corporation is declared a bankrupt, its assets are distributed among its creditors and it is relieved of any further responsibility for the payment of unpaid claims.

A corporation cannot be declared an involuntary bankrupt unless it has committed an act of bankruptcy. As stated in the Federal Bankruptcy Act, there are six acts of bankruptcy. Some of these acts are very similar in nature, and a debtor may commit one or more of them. The acts are as follows:

1. Transferring or concealing property with intent to delay or defraud creditors.

2. Giving preferences to one or more creditors by transferring property to them or by allowing them to attach property. The debtor must have been insolvent when such preferences were given.

3. Permitting, while insolvent, any creditor to obtain a preference through legal proceedings.

4. Permitting, while insolvent, any creditor to obtain through legal proceedings a levy or attachment of property and not vacating or discharging the same within thirty days.

5. Making an assignment for the benefit of creditors or having a receiver appointed because of insolvency.

6. Admitting in writing an inability to pay the claims of creditors and willingness to be declared a bankrupt.

In most cases anyone who wishes to have a corporation declared a bankrupt must allege and prove the debtor to be insolvent. Insolvency means that the liabilities of the debtor corporation exceed the worth of its assets at a fair valuation. Since in most cases a creditor cannot evaluate the assets of the debtor or even know the extent of its liabilities, he hesitates to bring suit. A person who makes a false charge of bankruptcy is liable in damages. Consequently, a corporation may continue in insolvency for many months before it is declared a bankrupt. During this period the assets are further dissipated with the result that bankrupts usually pay a relatively small percentage of their debts.

When a corporation is declared a bankrupt, a trustee and a referee are appointed. The trustee in bankruptcy may be appointed by the creditors, or by the court if the creditors fail to make an appointment. It is his duty to sell or otherwise realize on the assets and to pay the claims of creditors. The referee is appointed by the court and is authorized to represent the court in the closing out of the business and to see that the trustee deals fairly and equitably with all creditors. A separate trustee is appointed for each bankrupt, but one referee may supervise the administration of several bankrupt businesses.

The debts are paid in a definite order. In the liquidation of the debts of the bankrupt, the trustee pays first those debts which are given priority by the Bankruptcy Act. Preferred liabilities include Federal taxes, state and local taxes, the costs of preserving and administering the estate, wages due workmen and other servants which have been earned within three months in an amount not to exceed $600 to each claimant, and certain other obligations given priority by state law. After the preferred claims have been liquidated, any obligations secured by mortgage are paid, provided the

proceeds of the sale of assets pledged as security are adequate to pay them. Any cash remaining is distributed pro rata among the unsecured creditors such as the holders of unsecured notes and accounts due for merchandise. Since the corporation is bankrupt, the stockholders are usually paid nothing. If through some fortuitous development anything should remain after creditors have been paid, stockholders whose equities are preferred as to assets would be paid an amount not exceeding the par value of their stock or whatever amount is specified in the corporate charter, and the remaining balance, if any, would be distributed among the common stockholders.

The corporate charter is surrendered to the state. When the affairs of a corporation are wound up and its assets distributed, the corporation must notify the commissioner of corporations of the state which granted its charter and it must surrender the charter. If the corporation merely ceases to do business without rendering the proper notice, the annual franchise taxes continue to accrue; and while the corporation itself has no assets with which to pay taxes or penalties assessed, the directors and stockholders may become personally liable for the debts.

III. The Reorganization of Corporations

Large corporations which find themselves involved in financial difficulties usually do not sell their assets and distribute the proceeds among their creditors and stockholders. To do so would result in losses on forced sales; but what is more important, the corporate assets are usually worth more when they are kept together as a working unit or going concern than they are worth when sold separately. Moreover, modern corporations have much highly specialized equipment which cannot easily be converted to any other use than that for which it was originally intended. Instead of dissolving their businesses, such corporations usually reorganize.

Four types of reorganization will be described in the following pages: (1) the quasi-reorganization which affects only the equities of stockholders, creditor claims not being affected; (2) the composition with creditors; (3) the reorganization through receivership; and (4) the reorganization without receivership.

In a quasi-reorganization, a corporation may restate the value of its assets and of its capital stock on its books. After a corporation has carried on its business for several years, it may find that because of changes in the costs of construction or for other reasons,

the value of its properties as shown by its books is overstated. The company may also have accumulated a deficit through operating losses over a period of years. Both such developments are undesirable from the point of view of the stockholders. The overvaluation of assets makes necessary large charges against income to recognize the annual depreciation of the properties, and because of such charges it may be impossible for the company to show a net income for dividends. The accumulated deficit is a disadvantage because no dividends can be paid in future years until income has more than offset the deficit. Both of these difficulties may be met by reducing the amount of the capital stock. Such a reorganization, which affects the equities of stockholders only, is called a *quasi-reorganization.* No court procedure is required to effect a quasi-reorganization.

To illustrate the method of the quasi-reorganization, assume that the condensed balance sheet of a corporation is as shown below.

THE ESSEX CORPORATION

Assets		*Liabilities and Capital*		
Plant and Equipment	$1,100,000	Miscellaneous Liabilities		$300,000
Other Assets	500,000	Capital Stock (15,000 shares of $100 par value)	$1,500,000	
		Deficit (deduct)	200,000	
		Balance		1,300,000
Total Assets	$1,600,000	Total		$1,600,000

Since the corporation has a deficit of $200,000, it cannot pay dividends until it has had income of more than that amount. However, the company might reduce its capital stock to a par value of $50 per share and use the $750,000 reduction to wipe out the deficit, reduce the property values to $600,000, and create an unearned or capital surplus of $50,000. The balance sheet then becomes as follows:

THE ESSEX CORPORATION

Assets		*Liabilities and Capital*		
Plant and Equipment	$600,000	Miscellaneous Liabilities		$300,000
Other Assets	500,000	Capital Stock (15,000 shares of $50 par value)	$750,000	
		Capital Surplus (add)	50,000	
				800,000
Total Assets	$1,100,000	Total		$1,100,000

Several ways of changing the value of the capital stock in a quasi-reorganization are possible. The essential feature of a quasi-reorganization is the reduction in the value assigned to the capital stock. The following methods are possible:

1. The par value of the outstanding shares may be reduced. This is the method followed in the preceding illustration.
2. The number of outstanding shares may be reduced without a change in par value. Thus, the Essex Corporation might have reduced the number of shares to 7,500 at the old par value of $100.
3. The par value of the shares and also the number of outstanding shares may be reduced.
4. The shares may be changed from par value to no par value with a lower value assigned to each share on the books.
5. If the shares were formerly no par, they may be changed to par value with a lower value assigned to each share.
6. No par shares may be assigned a lower value with the same number of no par shares left outstanding.

The quasi-reorganization is effected by vote of directors and stockholders. If the par value of the stock is changed or if par value stock is changed to no par stock or the reverse, the approval of stockholders is necessary because an amendment to the charter is required. If the only change in the stock is a reduction in the amount assigned to no par shares on the books, the only requirement is a vote of the directors, though it might be desirable for the directors to bring such an important measure before the stockholders either for their approval or for their information. The consent of creditors is not required because their claims are not affected.

If the par value of the stock is changed or the number of outstanding shares is reduced, stockholders are required to surrender their old certificates in exchange for new certificates of the new par value or the reduced number of shares. In such cases, the stock exchange fixes a date as the last day of trading in the old shares. After that date, the stockholder can sell only the new shares in the market though he may continue to vote or to receive dividends on old stocks without making the exchange.

Several requirements should be observed in the quasi-reorganization. If the corporation had an earned surplus prior to the

quasi-reorganization, the reduction in the value of the properties should be charged first against it. The earned surplus should be exhausted before the paid-in capital (or capital surplus) is reduced. A full explanation of the transaction should be included in the financial reports in the year the change is made. Thereafter, the statements should indicate the date of the change, and earnings accumulated after that date should be described as having been earned after the quasi-reorganization was effected. It is desirable to make the changes in capitalization as of the close of a fiscal year. After the assets have been written down, they should still be shown on the books at not less than a fair value as established by appraisal. It would not be good practice in later years to write up the values of the assets or otherwise reverse the changes made.

Liabilities may be scaled down through a composition with creditors. Since a quasi-reorganization does not reduce the debt or the interest charges of the corporation, a more far-reaching change may be necessary. If two or more creditors will agree to reduce their claims against the corporation, they may enter into a written agreement to that effect. Such a contract, called a *composition with creditors,* is legally binding since the consideration for the agreement of any one creditor is a similar agreement on the part of the others. Creditors may profit by such an arrangement because the debtor is given an opportunity to rehabilitate his business to the benefit of all persons concerned. A decree of a court is not necessary to bring about a composition or to make it legal. The principal limitations of this method are, first, that it treats all creditors alike regardless of the priority of their claims, and second, that it provides no practical method of scaling down the claims which are secured by mortgages on property because the composition is optional. It is therefore not likely to go far enough to afford the debtor effective relief.

The affairs of a debtor may be reorganized through receivership. Prior to 1933, it was customary for corporations requiring a reorganization of their liabilities to go through receivership. This method is still possible, but since 1933 a cheaper and more effective way has been made available. The older and more cumbersome method must be explained, however, since it still may be used. An understanding of the older method is also necessary to a full understanding of the new.

The method of reorganization through receivership was not pro-

vided by the Bankruptcy Act of 1898, but it was devised by the courts to meet a definite situation. The difficulty arose from the fact that the debtor corporation required an extension of time in order to assure fair treatment of all creditors. The only procedure provided by the Bankruptcy Act was a suit in bankruptcy; and if a composition with creditors could not be effected, bankruptcy proceedings would result in compulsory realization of assets and liquidation of liabilities. The solution devised by the courts, without definite statutory authorization, was an equity receivership which in effect declared a moratorium on all debts until frozen assets could be realized or the affairs of the corporation so reorganized under the direction of a receiver that earnings again were possible. In this way the company was continued as a going concern.

The method of the receivership in brief was this: suit was brought by a creditor alleging the insolvency of the corporation. Such a suit under the National Bankruptcy Act was admitted to the Federal courts provided the corporation and the creditor were citizens of different states. The corporation replied to the charge by admitting the debt and also its inability to pay. The court then appointed a receiver to manage the property until solvency was restored or the obligations were scaled down through reorganization. A plan of reorganization was prepared by committees representing different groups of bondholders and stockholders. After the plan was approved by the court, the assets of the corporation were put up for sale, a new corporation was formed, and the new company purchased the assets of the old company. Thus, the reorganization was effected through the legal device of a new company which issued its securities in accordance with the plan of reorganization. The reason a sale of the assets of the old company was necessary was that the Bankruptcy Act made no provision for requiring security holders to compromise their claims other than through a sale; but if the assets of the old corporation were sold, the creditors necessarily had to be content with their shares of the proceeds. The receivership had further advantages in that the receiver could borrow money through the issuance of notes called receiver's certificates, and he could cancel certain contracts which had proved disadvantageous to the corporation. The receiver could also prevent one creditor from securing an unfair advantage because of his power to postpone the payment of any or all liabilities.

At the time of the receivership, committees were appointed to represent each group of security holders in working out a plan of reorganization. Committees to represent each group of creditors and stockholders were nominally selected independently by the creditors and stockholders, but they were in fact usually nominated by the corporation in coöperation with the bankers. Thus, a committee was announced to represent each group of bondholders, another to represent the commercial bankers who had made loans to the corporation, another the common stockholders, and another the preferred stockholders. The nominees were selected in advance of the receivership, and their names were frequently published on the day of the receivership. Each committee asked the security holders of that class to deposit their securities and to sign an agreement authorizing the committee to act for them. At times personal visits, telephone calls, and other pressure methods were used to gain deposit and acceptance. It was the duty of the protective committees to study the business and financial affairs of the corporation, find the best possible solution of its difficulties, and work out a plan of reorganization which would restore the corporation to solvency.

The interests of the committees were often in conflict with each other. Although the groups of security holders were interested in keeping down expenses, and in completing a workable reorganization as soon as possible in order that interest and dividend payments might be resumed, their objectives also differed in many ways. The owners of senior securities, such as first-mortgage bondholders, might be expected to make the least sacrifice, but the junior security holders, such as bondholders without mortgage security or the preferred stockholders, were in a position to block the adoption of the plan if too great sacrifices were asked of them. Some claims of doubtful legality might be recognized in order to avoid protracted litigation. The bankers had a personal stake in that they wished to retain their dominance in financing the company. The various conflicting interests had to be reconciled in some way and the plan eventually adopted was likely to be a compromise.

The following hypothetical plan suggests some of the possibilities in reorganization. Let us assume that the Ajax Corporation was unable to pay the interest on its bonds. Its balance sheet was as shown on page 221:

THE AJAX CORPORATION

Balance Sheet		*Date of Receivership*	
Assets	$75,000,000	Bank Loans (6%)	$1,000,000
Deficit	6,000,000	First Mortgage Bonds 5%	10,000,000
		Second Mortgage Bonds 6%	10,000,000
		Preferred Stock 6%	30,000,000
		Common Stock	30,000,000
Total	$81,000,000	Total	$81,000,000

The reorganization plan might provide the following:

Bank loans not to be disturbed.

Each $1,000 first mortgage bond to be replaced by a new $1,000 first mortgage bond bearing 3½% interest. The maturity date of the new bond is to be the year 2000 as compared with 1965 on the old bonds.

Each $1,000 second mortgage bond to be replaced by $500 in new 4% second mortgage bonds and $500 in 4% adjustment bonds on which the interest is payable only in case the earnings of the corporation are sufficient to pay it.

Each $1,000 preferred stock to be replaced by $500 in 4% preferred stock and $500 in common stock.

Each $1,000 in common stock to be replaced by $1,000 in common stock provided the owner pays $200 in cash to the corporation.

Security holders not wishing to make the exchanges agreed upon might be paid in cash as follows:

First mortgage bondholders $900 for each $1,000 bond.
Second mortgage bondholders $600 for each $1,000 bond.
Preferred stockholders $200 for each $1,000 par value stock.
Common stockholders $100 for each $1,000 par value stock.

If all of the security holders accepted the terms of the reorganization plan, the balance sheet of the corporation would be as follows:

THE AJAX COMPANY, INC.

Balance Sheet		*After Reorganization*	
Cash	$6,000,000	Bank Loans (6%)	$1,000,000
Other Assets	75,000,000	First Mortgage Bonds 3½%	10,000,000
		Second Mortgage Bonds 4%	5,000,000
		Adjustment Bonds 4%	5,000,000
		Preferred Stock	15,000,000
		Common Stock	46,000,000
Total	$81,000,000	Total	$81,000,000

The total of the outstanding securities was the same as before receivership, but the corporation had $6,000,000 cash which it could use for working capital or to pay security holders who did not agree to the plan. Annual interest charges were reduced as follows:

	Before	*After*
Bank Loans	$ 60,000	$ 60,000
First Mortgage Bonds	500,000	350,000
Second Mortgage Bonds	600,000	200,000
	$1,160,000	$610,000

The corporation assumed an obligation to pay interest on adjustment bonds in the amount of $200,000, provided earnings warranted the payment.

It is obvious that no corporation which becomes involved in financial difficulties is in a position to pay cash to a large percentage of the security holders. The plan would fail if it was unacceptable to many of them. Consequently the plan had to be so designed that most of the holders would make the exchanges of securities and pay the assessments. If the former stockholders did not subscribe sufficient cash to pay the dissenters, a part of the funds might be provided by the sale of securities through the investment markets.

Security holders were asked to approve the plan. After the plan was completed, it was presented to the court for its acceptance. If the court approved the plan, security holders were informed of its provisions and asked to agree to surrender their old securities in exchange for the new. Until 1933, they were not required to accept the plan and they could insist that in lieu of a reorganization, the assets of the corporation be sold in accordance with the provisions of the Bankruptcy Act and that the proceeds of sale be distributed. However, the plan of reorganization was in fact usually revised to gain acceptance, or the corporation continued in receivership for an indefinite period. Usually it was to the advantage of security holders as a whole to accept the plan.

The property of the insolvent corporation was sold at a receiver's sale. The courts believed that under the provisions of the Bankruptcy Act of 1898, they had no authority to compel the dissenting security holders to surrender their securities in accordance with a plan of reorganization. Since voluntary acceptance by

all of them was most unlikely, the courts developed the procedure of offering all of the assets of the corporation at a public sale, where presumably anyone could appear and make a bid. In practice there was usually only one bidder, and he was the banker representing the reorganization committees. He bought the properties, paying for them principally with securities of a newly organized corporation, formed for the express purposes of the reorganization. He also paid whatever cash was necessary to pay the dissenting security holders. The bankrupt corporation then proceeded to retire its own outstanding securities by distributing as a liquidating dividend the securities and the cash received for its assets. Thus, the technical requirements of the Bankruptcy Act were observed but the reorganization effected was somewhat beyond the original purpose.

Since only one bidder appeared at the sale, the price could not be established by competitive bidding. Instead, the minimum price, called the set-up price, was fixed in advance, and the minimum price became the actual price. The fixing of this price was a part of the plan of reorganization, and it had the approval of the court. The entire transaction which had the outward appearance of a sale was in fact merely a legal device to discharge the obligations of the corporation and to effect a redistribution of its securities and its liabilities.

Reorganization by receiver's sale was an unsatisfactory method. One objection to the receiver's sale was that it was a subterfuge or a method of accomplishing indirectly what could not be accomplished directly. A more important objection was that it was an expensive procedure. There were numerous and costly legal fees, for legal advice was necessary at every step. Even the costs of printing the agreements signed by depositors of securities and of engraving the new certificates were not small items. A new corporate charter was procured with its attendant fees, taxes, and expenses. Depositaries of securities, transfer agents, and registrars of new securities had to be compensated. The costs of transferring securities by registered mail was one of the smaller costs. The expenses of reorganization were borne directly or indirectly by the security holders. A third objection to the old method was the inability of the court to force security holders to accede to the plan. Some of them used the opportunity to drive an unfair bargain, whereas it would have been more equitable for all shareholders of a class to share alike in the benefits and the costs of the plan.

Reorganization without receivership is now possible. In 1933 an amendment to the Bankruptcy Act was passed providing for the reorganization of railroads without the formality of receivership or receiver's sale. This amendment, known as Section 77, was followed by a similar provision for industrial corporations in 1934 known as Section 77B. The amendment provided that reorganization might be effected upon application to a court taken upon the initiative of either creditors or management. A voluntary petition may be filed by the corporation without the necessity of admitting insolvency. The corporation is a debtor but not necessarily a bankrupt or insolvent business. A plan of reorganization may be effected with the approval of the court whereby the rights of either creditors or stockholders may be modified without the cancellation of the old securities and the issue of new ones. Under the amendments as well as under the old law, however, it is necessary to provide for dissenting security holders.

The principal advantage of the 1933 and 1934 amendments was that they made unnecessary the formalities of a sale of corporate property at an artificial or set-up price. They also made it unnecessary to solicit a deposit of securities incident to the receivership or even to form a new corporation. While the same purposes may be accomplished as before, the procedure has been much simplified.

There were several weaknesses in the amendments of 1933 and 1934. The most important weakness was that it left the control of the corporation during reorganization in the hands of its former officers and those associated with them, such as the investment bankers. It gave them a number of advantages over non-management groups in the formulation and the voting upon a plan of reorganization. For instance, the debtor could submit a plan for the consideration of stockholders and creditors at a meeting called for the purpose without permitting prior discussion or other consideration by any of them. If any other group wished to propose a plan, it was required to obtain prior acceptance by specified percentages of stockholders and creditors. The information given to security holders who were asked to vote upon a plan was not subject to adequate verification and control by the court or any other government agency. The judge of the court who supervised the reorganization proceedings frequently was unable to inform himself adequately as to the fairness of the plan to all parties or its feasibility in meeting the problems of the corporation. Consequently, plans of reorganization were designed to continue the con-

trol of the corporation in the hands of the old management and its investment bankers. Those groups were required to make a minimum of sacrifice in the common interest, and might in fact derive a benefit from the reorganization in the way of fees and the elimination of the equities and voting rights of any interests which might oppose them. These weaknesses have been corrected in subsequent legislation.

The 1934 amendment has been superseded by the Chandler Act. The Chandler Act, passed in 1938, is a new amendment to the Bankruptcy Act. It continues the plan of reorganization without receivership but it requires the appointment of an independent trustee to take over the reorganization and it also requires that the plan be approved by the court before being submitted to the security holders. An independent trustee must be appointed in reorganizations of industrial corporations having liabilities of $250,000 or more. To be independent means that the trustee cannot be a creditor, stockholder, director, officer, employee, underwriter, banker, or attorney of the corporation. Thus, the former officers can have nothing to do with the reorganization plan, and the trustee must determine their responsibility for the failure of the corporation with a view to legal action against them. The trustee must investigate and report on the financial condition of the corporation and formulate a plan. Hearings are held, and the plan is submitted to the court for its approval. If it is approved, it is later submitted to the security holders for their acceptance or rejection. To secure acceptance, however, unanimous consent is not necessary. The plan is considered approved if two-thirds of each class of creditors and fifty per cent of each class of stockholders favor it. No provision need be made for dissenting security holders, but the plan becomes binding upon all of them when the necessary majorities are procured. Moreover, the court may require the acceptance of a plan even though a majority of any group disapproves. Thus, the power of some creditors or some groups of creditors to drive a hard bargain is destroyed. It seems, however, that a plan will be forced upon dissenters only in cases where rejection is unreasonable. Acceptance of the plan may be required even though it provides unequal treatment of liabilities according to the date and the circumstances under which the liabilities were incurred. The purpose of this provision is to make possible the scaling down of liabilities due to certain persons and especially to the management who may have taken unfair advantage of the corporation.

A new feature of the Chandler Act is that the Securities and Exchange Commission must be asked by the court for an opinion on the plan in a reorganization involving debts of $3,000,000 or more. In smaller corporate reorganizations, the court may at its discretion ask for such an opinion. The opinion of the Commission is not binding upon the court; but after a plan has been approved by the court and submitted to the security holders for a vote, the information supplied to security holders must include an analysis of the plan by the Commission. The Commission evaluates a plan on the basis of its fairness to all parties concerned and also its feasibility or probable effectiveness. Although not provided by the Chandler Act, the Commission is in practice usually consulted while the plan is being formulated in order that any inequities or other weaknesses may be corrected while the plan is still in the formative stage.

The requirement of fairness of a plan does not mean that no sacrifices will be required of security holders. On the contrary, sacrifices are necessary to restore the financial soundness of the corporation. Fairness means that the sacrifices will be apportioned among creditors and stockholders according to the seniority of their claims with no group required to take losses out of proportion to those required of others. Feasibility means that under the plan the corporation has a reasonable prospect of success, with fixed charges so reduced that another default is not in prospect. Feasibility also means that the corporation will resume operations with an adequate amount of working capital.

One provision of the Chandler Act opens the way to Federal control of corporate financial practices. The law provides that no plan may be approved unless it meets the following specific requirements: All stock must have the right to vote. Voting rights must be fairly distributed among all classes of stock. The provisions with respect to terms, rights, and privileges of the several classes of securities must be fair and equitable. The plan must require annual financial reports to security holders, and such reports must be prepared in accordance with sound business and accounting practice. These provisions may in time prove to be very significant.

If a reorganization plan is not adopted, the corporation goes through bankruptcy. When a plan is approved by the court, the judge fixes the time allowed for approval by the security holders. Later he may grant an extension of time if this appears necessary. If the plan is not approved by the necessary majorities by the ex-

piration of the time set, the court may declare the corporation bankrupt, or it may dismiss the reorganization proceedings. Either action by the court means bankruptcy and the sale of the assets of the corporation in the manner developed by the courts prior to 1933.

Although the provisions of the Chandler Act apply only to industrial corporations, a similar procedure for the reorganization of railway corporations has been provided by amendments to the Bankruptcy Act passed in 1935. Supervision of the reorganization of railway corporations is entrusted to the Interstate Commerce Commission which must approve any railway reorganization plan and which may also formulate a plan of its own, subject to approval by the courts. Trustees appointed by the courts must have the approval of the Commission, and the work of the protective committees is also subject to its supervision.

The new legislation embodies a new approach to the problem of corporate reorganization. The procedure followed in reorganizations prior to 1933 was based upon the assumptions, first, that the protective committees truly represented the security holders, and second, that equitable procedures were observed by all parties. Neither of these assumptions was well founded. The committees were too closely affiliated with managements and bankers. The public interest requires that principles of fair dealing be observed in all arrangements between managements, creditors, and stockholders. The reorganization of large corporations is not entirely a private affair, but is related to a smooth functioning of the entire economic system. The new methods are designed to lessen the shock of corporate failure, to provide a less expensive method of reorganization, and to ensure an equitable arrangement for all parties concerned.

One important result of the new legislation has been a decline in the influence of bankers over corporations and an increase in the influence of government. The bankers no longer control the formulation of the plan but their role has been reduced to that of offering suggestions to the court. Final decision is made by the trustee and the judge of the court. The Securities and Exchange Commission and the Interstate Commerce Commission play a very important part, for the advice of an impartial government agency carries great weight with the court. The growing control of the government over business organization is extensive and significant.

Questions

1. What are the actions or developments which may bring the life of the corporation to an end?

2. If the liabilities of a corporation exceed the value of its properties, why not let the creditors foreclose on their mortgages and take over the properties in settlement of their claims?

3. What is bankruptcy? Distinguish between voluntary and involuntary bankruptcy.

4. What is an act of bankruptcy? What actions constitute acts of bankruptcy?

5. How can a creditor know that a debtor is insolvent? What is the danger in charging that a person is insolvent when he is actually solvent?

6. What is a preferred liability? What is a secured liability? What is an unsecured liability?

7. Why should the corporate charter be surrendered to the state when the affairs of the corporation have been liquidated?

8. What is a quasi-reorganization? What is accomplished by it?

9. How may the capitalization of the corporation be changed in a quasi-reorganization?

10. What requirements should be observed in a quasi-reorganization?

11. What is a composition with creditors? Why is it not usually sufficient to relieve the debtor?

12. What is the advantage of the receivership in affording relief to a debtor corporation?

13. Trace the procedure for reorganization through receivership.

14. What costs are involved in reorganization through receivership?

15. How are the interests of committees representing the security holders in conflict with each other?

16. What has the banker to gain from reorganization through receivership?

17. What are the tests of a good reorganization plan?

18. Why was the plan of the receiver's sale devised under the provisions of the Bankruptcy Act? Why is a sale no longer required?

19. What are the advantages to security holders of reorganization without receivership? How has the new plan affected the power of the bankers over business organization?

20. Why is Congress concerned with methods of corporate reorganization? Is this a social problem or is it a private affair affecting only the corporation and its security holders?

CHAPTER XIV

Economics of the Corporation

The many years of successful experience with the corporation and its general acceptance as a form of business organization indicate that it is a valuable business and social institution. Nevertheless, the corporation has given rise to grave social problems, and it is not always the most satisfactory form of organization from the point of view of the enterpriser himself. In the present chapter some of the threads of the discussion of the corporation as found in preceding chapters will be drawn together, and its advantages and limitations will be indicated.

I. The Business Point of View

That the corporation has important business advantages is shown by its general acceptance as the prevailing form of organization in almost all branches of manufacturing, transportation, trade and distribution, finance, and public-utility industries. The modern economic system could hardly have been built up without it. The following are its most important business advantages:

1. The corporation affords great convenience in settling legal affairs. It facilitates the holding and transferring of title to property. It permits suits at law to be brought in the name of the corporation without bringing all stockholders into court. Likewise, suits may be brought against the corporation without the necessity of suing all of the stockholders.

2. The members enjoy limited liability. This really means that the purchaser of the stock has no liability if he has paid par value for it; or if he has paid less than par value, he is liable only for the difference between the par value and the issue price. Without the protection of limited liability, a prospective investor would be afraid to diversify his interests among a number of businesses. If he did so, a failure of any one of the companies in which he made an investment would subject him to the risk of losing his entire capital.

The limited-liability feature makes possible the wide diffusion of ownership which characterizes modern business.

3. The corporation has continuous existence. This makes possible its carrying out of business policies without constant reorganization. Despite the changing ownership of its stock, the large corporation continues to make and execute contracts and to carry out all sorts of business transactions without interruption. This would be impossible if the business were conducted as a partnership.

4. The shares may be transferred easily. This follows in part from the attribute of continuous existence, but there is added the feature of a stock system which permits capital to be divided into a large number of transferable shares, each share being of small amount. The stock may be disposed of without consulting the other members, and its sale has no effect upon the existence of the corporation. The ease with which one may dispose of his interest in a corporation by selling his stock encourages people of all degrees of wealth to buy stock. Thus, capital is obtained from a great many sources.

5. The owners are relieved from the necessity of participating in the management. Paid managers conduct the business for the owners. The managers usually have an important stake in the financial success of the enterprise, particularly in small corporations, although the management is sometimes separated from ownership. The small investor is permitted to make his investments in varied enterprises without knowing much or anything about how to manage any of them.

6. The shareholders have no power to act as agents for the corporation. With wide diffusion of stock ownership, this attribute assumes great importance and, indeed, becomes a necessity.

7. The corporate system is universally accepted. This does not mean that the state laws are uniform or that all questions of corporate organization have been finally adjudicated by the courts; on the contrary there is the greatest diversity of corporation laws as between the various states, and many questions pertaining to corporate powers have yet to be passed upon by the courts. What is meant by the universal acceptance of the corporate system is that the corporate form is universally recognized, and that its more important characteristics are the same in every state. This gives the corporation a great advantage over the joint stock company and the business trust.

The corporate form has certain business disadvantages. While the advantages of the corporation in most cases outweigh the disadvantages, it must not be supposed that everything is in favor of the corporate form. On the contrary, many small businesses and some large ones find other forms of organization better suited to their needs. This is especially true in those businesses which, either because of the wealth of the owners or because of the small amount of capital required, do not need to draw upon numerous and widely scattered sources for their capital. The principal disadvantages of the corporate form are as follows:

1. Taxes are higher for the corporation. The corporation is subjected to numerous kinds of fees and taxes, and in the aggregate these may become burdensome. Owing to the impersonal nature of the corporation, legislatures have often found it the line of least resistance to raise corporation taxes when the state was in need of additional revenue. The corporation is required to pay an incorporation tax and filing fees when the charter is received. Amendments to the charter also require the payment of taxes. If the corporation wishes to do business in another state besides the one from which it received its charter, it must in most states pay additional fees to enter and do business in that state. The stock of the corporation and also its property are subject to property taxes, though many states, recognizing that this really constitutes double taxation and that the tax on stock is relatively easy to evade, have provided for a lower tax rate on stocks than on physical property. The income earned by the corporation is subject to corporate income taxes; and if the earnings are paid to the stockholder as dividends, they are subject to additional taxes as personal income.

Prior to 1937, many individuals with large incomes found that they could reduce their personal income taxes by organizing what are known as personal holding companies or vest-pocket corporations. There are two characteristics of the personal holding company as defined in the revenue act: first, fifty per cent or more of its stock is owned by not more than five persons; and second, eighty per cent or more of its income is derived from dividends, interest, royalties, or annuities, from gains from the purchase or sale of securities (except in the case of dealers in securities), from personal service contracts, and from other sources of a personal nature. Such a corporation paid the corporate tax on its income; but if the company paid no dividends, the tax was less than it would have been

upon the individual because the high surtaxes on large personal incomes were avoided. Personal holding companies were subjected to such high corporate taxes under the Revenue Act of 1937 that the scheme is no longer profitable.

Inheritance taxes formerly were increased by the use of the corporate form because both the state in which the business was incorporated and the state in which the deceased had his residence might levy taxes. In 1932 the Supreme Court held that an inheritance tax on corporation stock might be imposed only in the state where the deceased had maintained his residence.[1] Transfers of corporation stock, and also transfers of shares in a joint stock company or a business trust, are subject to state and Federal taxes, whereas the sale of a proprietary interest or an equity in a partnership is not taxed.

2. Legal formalites must be observed in organizing and conducting the business. The procedure for procuring the charter, for holding organization meetings, and for drawing up and adopting the by-laws must be complied with. Corporate funds must be kept separate from personal funds of the stockholders, and dividend payments can be made only when legal requirements have been met. Funds cannot be transferred from one corporation to another even though one stockholder owns all of the stock in both corporations. Any powers of directors can be exercised only by the board in meetings duly called and conducted. Minutes of meetings must be kept as evidence that the requirements of the law have been complied with.

If all of the stock of a corporation is held by one person or a small group of persons, all of whom are in the same family, informalities in management have sometimes been permitted, provided the interests of creditors are not adversely affected.[2] For example, if all of the stock is owned by the members of a family, the funds of the corporation may be used for the payment of family expenses. Persons becoming creditors later are not permitted to complain of this practice, though persons who were creditors at the time might have just ground for complaint. Stockholders and directors who conduct the affairs of the corporation in such an informal manner are subjecting themselves to the danger of personal liability to creditors, however, as the laws are usually quite strict.

[1] First National Bank of Boston *v.* Maine, 284 U.S. 312 (1932).

[2] See "Judicial Supervision of the One Man Corporation," *Harvard Law Review*, April, 1932, Vol. 45, pp. 1084-1089.

If one corporation owns all of the stock of another, the two companies may have the same officers and directors, and the separation of the affairs of the two corporations may be difficult. Nevertheless, if the holding company is not to be liable for the debts of the subsidiary company, the following requirements must be carefully observed: (1) Separate financial units must be set up and maintained. (2) Separate records must be kept. (3) Two management structures must be maintained, and each officer and director must be careful to indicate at all times the corporation for which he is acting. (4) The two corporations should not be represented to the public as being a single company.[3]

3. The corporation lacks some of the flexibility of the partnership. The corporation comes into existence as the result of the charter which defines its powers. If it appears desirable for the corporation to change its organization or its powers, an amendment to the charter must be voted by the stockholders and approved by the state which granted the charter, whereas a change in a partnership agreement requires only the mutual consent of the partners. This is not a serious objection to the corporate form, but it emphasizes the necessity for observing legal formalities.

4. The individual owner runs the risk of loss of control over the business. In a partnership the partners must agree unanimously upon important policies and upon the admission of new members. In a corporation most questions are settled by a majority vote of the stock, and usually each share of stock has one vote. If a stockholder does not like the way things are being managed, the only recourse he has, in the absence of fraud, is to sell his stock.

5. The corporate form may not properly motivate the management. In a small partnership in which all of the members have a vital interest in the success of the business, the partners are likely to apply themselves better and to be more interested in effecting economies than is the case in a large corporation. However, great motivation may be achieved in the corporation if all of the stock is held by a relatively small number of persons.

II. The Social Point of View

Adam Smith in his *Wealth of Nations* pictures the individual as

[3] W. O. Douglas and C. M. Shanks: "Insulation from Liability through Subsidiary Corporations," *Yale Law Journal,* December, 1929, Vol. 39, p. 129. See also Frederick W. Powell: *Parent and Subsidiary Corporations;* Callaghan and Co., Chicago, 1931.

promoting the general good in pursuing his own private ends, and to a certain extent this is a true and correct description. The individual ordinarily would attempt to enter the line of business which offered him the greatest opportunity for profit, and one might expect that this would also be the business for which the social need was greatest. He would also be motivated to operate the business in the most efficient manner and to produce goods and services in the largest possible volume. Thus, the "unseen guiding hand" that directs the individual into the most profitable business opportunities also directs the whole economic system to satisfy human wants with least cost, and the personal and the social points of view are much the same.

When we consider the economics of the corporation, we find that it is partially true that the business and the social points of view are the same. Businessmen constitute a substantial part of society, and to the extent that the corporation meets their needs it is serving one part of society. The corporation also helps in the production of goods and services, which is the primary function of business. In many respects, however, there is a conflict between the business and the social points of view.

The corporation has aided in the development of our national wealth. The corporation has made it possible for large-scale enterprises requiring great aggregations of capital to procure the necessary funds. It has not only made possible the pooling of the savings of large numbers of people in a single enterprise by offering an easy method of investment, but it has also encouraged people to save and thus has increased the total productive capital of society. The corporation itself, through the reinvestment of its surplus earnings, has contributed directly to the accumulation of the productive equipment.

The states have ceased to question the necessity for the issuance of corporate charters. Formerly when charters were granted by legislative act, every provision in a proposed charter was subjected to question and its inclusion had to be justified. The purpose for which the corporation was being organized had to be consistent with the public interest. The powers granted the corporation were limited to those which were necessary for the accomplishment of its general purposes. Its authorized capital and its power to borrow money were in keeping with its needs. The kinds of stock to be issued were carefully inquired into, and the rights of each group of shareholders were protected. If the required capital

could be raised just as well by a partnership as by a corporation, the charter was not granted. If the charter provisions seemed likely to lend themselves to abuse, they could be amended by the legislature. No doubt the legislatures often failed to exercise proper control and were influenced at times by political pressure, but there was at least a measure of supervision.

The check to the granting of charters has now disappeared. The charter is drawn up by the attorney for the incorporators and filed in the office of the secretary of state. It is given a perfunctory examination by a minor employee who sees that the provisions of the general incorporating act have been complied with and that the incorporating fees are paid. Until recently the stock could be sold without informing the purchasers of important charter provisions. As noted earlier, however, the Securities Act and the Securities Exchange Act now require that a copy of the charter be filed with the Securities and Exchange Commission for public reference before securities can be sold in interstate commerce.

Modern incorporation statutes permit the use of many questionable financial devices. The charters may contain any one or more provisions which increase the authority of the directors and officers or the rights of certain groups of shareholders at the expense of others. These include, for example, non-voting stock, convertible securities, stock-purchase warrants giving the holders the right to buy additional shares at a stipulated price for an indefinite period, founders' stock giving one small group of shareholders a fixed participation in the dividends, and no par stock. Along with these devices have come the denial of the preëmptive right and the right to examine the stock records, and the encroachment upon other rights of the stockholder.[4] The use of these devices together with overvaluation of properties and excessive promoters' and bankers' profits have in many cases made it possible for adventurers to reap large profits at the expense of the stockholders and the public. Thus, the corporation, while increasing the income of society, has possibly increased the percentage of the social income which goes to promoters, financiers, and managers. It has increased the inequality of wealth and created numerous social problems. Corporate abuses have at times caused many investors to lose con-

[4] For further discussion of this problem, see A. A. Berle, Jr., and Gardiner C. Means: *The Modern Corporation and Private Property, passim,* Callaghan and Co., Chicago, 1932. A shorter account may be found in Paul M. O'Leary: *Corporate Enterprise in Modern Economic Life,* Harper and Brothers, New York, 1933.

fidence not only in corporate managements but even in the entire system of private enterprise.

The stockholder has become a mere investor in business enterprise. Theoretically the stockholder is a part owner of the business but in fact he does not consider it his function to help formulate business policies. He thinks of himself as an investor who hopes to receive dividends and ultimately to sell his stock at a profit. The theoretical difference between stocks and bonds has largely disappeared, at least in the mind of the average stockholder. Control of the corporation has been abandoned to a group of managers whom the stockholder does not know and over whose actions he has little control.

The corporate system enables the management to make decisions of far-reaching importance. The decision to expand or not to expand the productive capacity of industry now rests largely with the management. The funds for expansion are provided in part by the reinvestment of profits. The corporation uses a part of its net income for the acquisition of additional plant and equipment instead of dividends. In some cases the funds are provided by the sale of additional issues of stocks or bonds. New issues of stock are usually sold to former stockholders while bonds are sold in the open market through the facilities of investment bankers. In either case, the investor is not in a position to decide whether the expansion is wise but must rely largely upon the judgment of the management. Thus, the direction in which the capital equipment of society shall expand is usually determined by persons who supply a very small part of the funds required.

If the decision to expand is made by the management after a careful comparison of the advantages of the possible uses that might be made of the funds, the allocation is more likely to be better for society than if the choices were made by someone else. The management knows more about the opportunities and the hazards of a proposed venture than anyone else, and the rate of return which may be expected on an investment is probably as good a basis for judging the social desirability of various alternative proposals as is available. However, the investor cannot be sure that the decision of the management is based upon either social advantage or anticipated income to the corporation. The danger is that the management may favor expansion of the plant and equipment of the corporation for its own personal profit or prestige. People often like to head large enterprises because mere size may be a jus-

tification for high salaries or may give added prestige in social or business circles. There is reason to believe that corporations have sometimes branched out into foreign markets for the personal satisfaction of the managers who wished to be associated with a company which had a sales office or a factory abroad.

It is possible that the separation of ownership from management may have the opposite effect from that just indicated. A new venture always carries a risk of loss, and the officers may fear personal criticism if a venture is not successful. They may feel that it is better to let things drift and to make sure of their present positions than it would be to stake their future upon a new speculative undertaking. This is probably true in some cases, but it is not typical of the general situation.

There is another risk that the purchaser takes in advancing funds to the corporation for capital expansion. This is the possibility that the corporation will not faithfully observe its agreements. As it was noted in the discussion of bonds, managements have sometimes misused the proceeds of security sales. Thus, the purchaser of a new issue of securities must assume the hazards attendant upon a proposed venture and also the risk that his funds may not be used in the manner which he contemplates.

The social justification of salaries paid by large corporations has been questioned. Formerly the salaries and bonuses paid to corporate executives were secret; but in the case of most large corporations, the compensation of executives is now a matter of public record. A study of the total salary and bonus paid to 264 top executives just before the war showed a median salary by industrial corporations of $79,200, by public-utility corporations $48,600, and by railroad corporations $40,600. Forty-four per cent of the executives received more than $87,500, and almost twenty per cent received more than $112,500.[5] Small stockholders have sometimes questioned the necessity or the desirability of such large payments, particularly since the fixing of salaries seems to be beyond their direct control.

Whether large corporate salaries are merited is not easily answered. In view of the importance to stockholders of sound management decisions and the losses which might be sustained by errors made at the top, the services of highly paid executives may well be worth all that is paid for them. Moreover, the salaries paid by

[5] R. A. Gordon: *Business Leadership in the Large Corporation*, p. 275, Brookings Institution, Washington, 1945.

large corporations are a smaller percentage of the income than are the salaries paid by small corporations. One study showed that large companies paid 4.9 per cent of their income in salaries and small companies paid 25.5 per cent.[6] Perhaps large salaries are a necessary reward for talent far greater than the average, but it might also be possible for the corporation to purchase the services of its officers at a lower price.

The corporation has made shares in our national wealth transferable. The bonds and stocks of the corporation which represent the ownership of corporate property are freely traded on the exchanges and in over-the-counter markets, and the owner can receive cash for them when he needs it. This attribute of the corporation has great advantages, for it has made it possible for persons of small means to share in the earnings of our large enterprises. Investors can move from place to place as their work may require while they still maintain their corporate investments, which yield them a dividend or interest income. The corporation makes it possible for these people to invest their savings to the advantage of themselves and of society.

As a result of the ease with which individuals can sell securities to others, the stockholder has come to look upon his investment as liquid. While he can convert his stock into cash in a short time, it is not liquid in the sense that the short-time loans of a bank to provide merchandise inventory for a business are liquid, because the assets held by the corporation as a value behind the stock may be permanent or fixed assets. The stock is liquid only in the sense and to the extent that it can be sold to others. In ordinary times, no difficulty is experienced by the shareholder, but when great numbers of stockholders demand cash at the same time, the stock market is overwhelmed with selling orders and security prices slump. Stock market breaks, with all that they imply for the security holder, the banks, and business generally, are one of the consequences of the corporation with its transferability of shares.[7]

The best corporate policy is one of strict regulation. Although the corporate system has undoubtedly contributed much good to society, it has also been harmful in many individual cases. The government should therefore adopt a policy of regulation that per-

[6] J. C. Baker: *Executive Salaries and Bonus Plans,* McGraw-Hill Book Co., New York, 1938.

[7] For full discussion of this problem, see A. A. Berle, Jr., and Victoria J. Pederson: *Liquid Claims and National Wealth,* Macmillan Co., New York, 1934.

mits the corporation to function as effectively as possible but prevents or minimizes its abuses. Until recently, this seemed to be a responsibility for the states, but during the last fifty years they have gradually abandoned any close supervision over corporations. It has therefore become necessary for the Federal government to establish supervision, and the tendency is in the direction of increased Federal control.

Questions

1. How does the corporate device facilitate the raising of capital?

2. Is limited liability a social as well as an individual advantage?

3. Formerly holders of stock in all types of corporations were liable, in case of insolvency, for an assessment equal to the par value of their stock if necessary to pay creditors. What was the purpose of this provision? Why was it repealed?

4. What is the advantage in having people who know nothing of chemistry own stock in corporations which manufacture chemicals? Is there any disadvantage?

5. What taxes are higher for a corporation than for a partnership? Are the higher taxes socially justifiable?

6. What are the two requirements of the personal holding company?

7. Is the observance of the legal formalities of the corporate form a serious objection?

8. What did Adam Smith mean by the "unseen guiding hand"? To what extent is the figure valid?

9. How has the corporation aided in the development of the national wealth?

10. What abuses may result from the use of non-voting stock? From convertible bonds or preferred stock? From stock-purchase warrants? From denial of the preëmptive right?

11. Does the average stockholder think of himself as having a responsibility for the formulation of corporate policies? Does it make any difference in his attitude if he owns preferred stock or common stock?

12. What is meant by the statement that the corporation has made our national wealth transferable? What is the advantage to the investor? What is the effect upon our economic organization? Are there any undesirable consequences?

PART THREE

The Investment Company

CHAPTER XV

Development of the Investment Company

The investment company is an institution which may be organized in any one of several ways. Some are joint stock companies, some are business trusts, and some are corporations. It cannot therefore be classified under any one form of organization; but it is sufficiently important in our economic life as to require attention, and it is here placed in a class by itself.

As originally developed in England and other European countries, the investment company was a corporation organized for the purchase of high-grade securities for investment purposes only. It bought largely bonds and preferred stocks, that is, securities which usually carried no right to vote. In the United States, it has purchased principally common stocks and is therefore an institutional stockholder. As a stockholder, it has created a twofold problem: First, its interests as an investor must be protected against abuse by corporate managements of companies in which it has invested. Like most other stockholders, investment companies usually do not take an active interest in the affairs of corporations whose securities they own; and they are often not represented at the meetings of stockholders. Instead, they depend upon the honesty of management and the legal safeguards of stockholders previously described. Second, the investment company sells its stocks and bonds in the securities markets; and since it deals largely in cash and securities rather than tangible assets, its management is peculiarly in a position to take advantage of its own stockholders if it so desires and if legal safeguards are not provided. The investment company has therefore required special legislation for the protection of its security holders.

The investment company is often more than an inactive or in-

different stockholder. In some cases two or more investment companies are under the same control, or an investment company is under the same control as a corporation which owns a large percentage of the stock of a manufacturing or other company. In such cases, the investment company combines the voting rights of stock which it owns with the rights of stock owned by others for purposes of control. Thus, the investment company may resemble a holding company. In other cases, the investment company may buy securities of some corporations for strictly investment purposes but acquire a controlling interest in the voting securities of other corporations. Such an institution is an investment company with respect to some securities and a holding company with respect to others.

I. Origin and Development Abroad

The investment company is a relatively new institution in the United States, but it has had a long history in Europe and has been particularly successful in England. The idea of the investment company is believed to have originated in connection with the administration of the estates of deceased persons. The estate was kept intact, and each heir received an interest in the trust fund. If the shares in such an estate were made transferable, the trust would resemble the modern investment company.

Investment companies were first organized on the continent of Europe. The first investment company is believed to have been organized in Brussels in 1822. Investment companies were also organized at an early date in Switzerland, and they have met with some success in France and Holland. They did not thrive on the continent as they did in England, principally because the continental countries did not have a large volume of capital for export. Moreover, the preference of many classes of people on the continent has been for government bonds rather than corporate securities.

Investment companies were organized in England for foreign investment purposes. England very early had a supply of capital in excess of domestic needs. The industrial revolution began in England many decades earlier than elsewhere and her needs for capital for development at home were met at an earlier time. The smaller territory of the British Isles also required a smaller railway mileage with less capital outlays. The excess of capital at

home was reflected in a low rate of interest on domestic investments, which stimulated the export of capital. Individuals had difficulty in managing investments abroad; and after a period in which severe losses were suffered, investment companies began to to be organized. The English investor was permitted in this way to purchase the stock or bonds of a domestic corporation with whose management he was familiar, and at the same time he received the higher returns which were to be realized from foreign investments. The risks attendant upon such investments were reduced both by better selection made by specialists in investment analysis and by the wide diversification.

The first investment company in Great Britain was a Scottish company organized in 1860. Another was organized in London in 1863. In 1866 the securities of twelve investment companies with a combined capital of £6,500,000 were listed on the London Stock Exchange. During the next two decades such companies had a very rapid development, and by 1888 they had been generally accepted as an investment institution.

During the nineties the investment company received a decided check. In 1890 England suffered a severe financial crisis, which was precipitated in part by the failure of the banking house of Baring Brothers. The crisis had been preceded by a speculative era in which a number of unsound financial practices had developed. Investment companies had been created in great numbers, and many of them had bought securities which were too speculative. They had not sufficiently diversified their holdings either by industries or by countries. Some of them had invested as much as one-third of their capital in the securities of one South American country. Most of those companies had heavy losses.

Investment companies gradually re-established themselves during the next decade. Unsuccessful ones were reorganized or merged with others. By the beginning of the First World War, they were on a sound financial basis. They were under conservative management and had sound and well-diversified investments.

The record of the English investment companies has been creditable. There are now several investment companies in England with more than seventy years of successful experience. They have passed through several depressions and two world wars. In wartime the needs of the government for loans have been partly met by the investment companies. They have sold many of their for-

eign investments, using the proceeds to buy government bonds. They have also loaned many of their securities to the government to be deposited as collateral for foreign loans. In this way they have aided the government to obtain foreign exchange for the purchase of supplies in foreign countries.

Out of the English experience principles of management were developed. Successful English companies observe the following principles:

1. Investments should be diversified. By industries, the holdings usually include commercial and industrial securities, railways, public utilities, banking securities, and governments. By countries the largest investments of many of the companies are in securities of Great Britain and British dependencies, and these investments have been augmented by developments during the war. Substantial amounts are still invested in Central America, South America, Egypt, South Africa, the United States, and other countries.

2. The investment company should be large enough for efficient management. A total fund for investment of £2,000,000 is regarded by many as the optimum if not the maximum. This size permits of a portfolio of 700 holdings of almost £3,000 each. However, many companies have much smaller portfolios.

3. The investment company should not take great risks. The reduction in risk which is afforded by diversification permits the company to invest a part of its capital in common stocks, but the larger part of it is invested in senior securities, principally bonds.

4. Safety of principal is the first consideration, and income and and appreciation of assets is second. This conservative investment policy permits the company to raise a part of its own capital by bond issues bearing a low rate of interest, but its issues are largely common stocks.

5. A conservative accounting policy should be followed. In periods of rising securities markets, the gains should be set aside in a reserve to take care of losses in subsequent periods. Only after a period of years should such gains be made available for dividends.

6. The management should be independent. When companies are closely associated with banking groups, they may purchase securities which the bankers have for sale but which are not necessarily suited for investment companies.

II. Development in the United States

In the United States the investment company had a slow development until about 1924. Up to the period of the First World War, American investments abroad were negligible in amount. Moreover, the American public had not been accustomed to the idea of buying corporate securities. In most communities there was opportunity for investment in farm or city real-estate mortgages and in loans to local business enterprises. Additional funds were deposited in savings banks and commercial banks or were paid as premiums on life-insurance policies. Thus, there was no need for an institution like the investment company.

Interest in investment companies began to be manifested during the First World War. When the United States began to make loans to European governments, the idea of investment companies began to be advanced; and a few of them were organized. One of the earliest was the American Foreign Securities Company, organized in New York in 1916. However, the few investment companies organized during the war period were small in size and their securities were not widely distributed. In 1919 Congress authorized the formation of investment companies for the purpose of financing foreign trade, but no such companies were formed under the Federal law because the investing public was not yet ready to buy their securities.

Investment companies were formed in great numbers during the decade of the twenties. The popularity of the investment company was based in large part upon the belief that on the average the investor could earn more through the purchase of common stocks than through investments in securities bearing a fixed rate of return such as bonds or preferred stocks, provided the securities were carefully selected. The investment company was generally believed to assure proper selection: first, because the managements of such companies were experts in investment analysis; second, because they could give continuous study to activities in the securities markets and to changes in investment prospects; and third, because the investment company made possible a wide diversification.

The prestige of investment companies greatly increased during the years 1925 to 1929. Companies which had been organized a few years earlier made great profits because they had purchased common stocks with the greater part of their funds, and they benefited by the general rise in security prices. Acting on the assumption

that stock prices would continue to rise indefinitely, speculators bought at advancing prices the outstanding securities of investment companies. Promoters and banking houses hastily organized new companies whose securities were also in active demand. Safety of principal was neglected by both investment company and investor. The prevailing idea was capital gain. Prices quickly advanced in an already overpriced market. Investment companies, formed in the bull market, were expected by their stockholders to buy stocks at the prevailing prices in order that they might profit by a further advance. This situation was unfortunate not only for the investor but also for the investment company which was destined to become unpopular as rapidly as it had achieved popularity.

A realization of these facts, together with additional declines in the securities markets, led to a steady decline in the volume of new issues of investment companies after 1932. A further reason for the decline in new issues was the continuous offering of United States Government bonds which afforded an alternative and safe investment.

Investigation of investment company abuses led to Federal regulation in 1940. While the investment company was having its remarkable rise during the decade of the twenties, regulation was confined largely to state securities legislation which has been seen to have been ineffective. In 1935, the Securities and Exchange Commission began a comprehensive investigation of investment company organization and policies. The report disclosed a long list of objectionable practices. In 1940, Congress passed the Investment Company Act which brought investment companies under Federal regulation.

Several types of investment companies have been developed. From the point of view of the degree of freedom given the management in selecting the investments of the company, investment companies are of four kinds: the management company, the fixed trust, the semi-fixed trust, and the common or commingled trust fund.

1. *The management company.* The management company follows the principles of the European investment company in offering the advantages of management as well as diversification. The directors and officers can invest the funds of the company as they please, subject to certain limitations in the charter. They can sell any of the securities owned and buy other stocks and bonds as they please. The charter may limit the percentage of the total invest-

other means were sufficient to assure control of the corporate board of directors.[1] Many of these activities and control devices are now illegal under the Investment Company Act of 1940.

From the point of view of provisions for the redemption of their own securities, management companies are classified as *closed end* and *open end*. The closed-end investment company is one which does not contract for the redemption of its outstanding shares of stock. An investor in the shares of a closed-end company must sell the stock in the market in order to realize on his investment. The open-end company is one which agrees to redeem its outstanding stock at any time upon request from the owner of the shares. The price paid the stockholder is computed by dividing the total market value of the securities owned by the number of outstanding shares, and subtracting a stated service charge. The method of determining the cash surrender value of the shares is stated in the contract for the original issue and sale of the stock.

2. *The fixed trust.* This company offers diversification but no management. The plan of organization is that the banking house sponsoring the company turns over to a trustee a definite number of shares of a number of corporations, or the purchase price of a certain number of shares. The equity in the shares or the cash composing the fund is represented by trustee shares, each share representing a prorata interest in the fund. For example, the fund may be divided into 1,000, 2,000, or 10,000 shares. These shares are sold to the public at a price representing the cost of the stock plus a loading charge to take care of the expense of setting up the fund and to provide a profit for the sponsors. The trustee is authorized to pay all dividends received, and usually the proceeds of the sale of all stock rights and stock dividends, to the holders of the trust certificates who share pro rata in the distributions. Investment companies of this type thus involve three parties: (1) the creator or organizer of the trust, which may be an investment banking house or corporation organized for the purpose of creating investment trusts and selling their securities to the public; (2) the trustee who holds title to the securities and cash composing the trust fund and issues the trust certificates; and (3) the purchasers of the securities who are the beneficiaries. Companies of this type are usually not incorporated, but are organized as business trusts.

[1] For examples of the various types referred to in the text, see Securities and Exchange Commission, *Report on Investment Trusts,* Part I, Washington, D.C., 1938.

The shares which they issue rarely have a par value. The fixed trust is sometimes called the unit investment trust or unit investment company because each of its shares represents an equity or interest in a unit of specified securities.

Fixed trusts are dry or inactive trusts. The trustees do not possess the large powers of management and are not subject to the liabilities of active common-law trustees. For the most part a trustee is a mere custodian. He merely holds the investments in trust for the beneficiaries, receives the income on them, and distributes the income among the holders of the trust shares. The trustee is usually a bank or trust company.

3. *The semi-fixed trust.* This company resembles the fixed trust, with the difference that under certain circumstances the trustee may sell some of the stocks in the original trust fund and invest the proceeds in other stocks in the original list or an alternate list included in the trust agreement. The power of the trustee is definitely limited, the sale of stocks being permitted only in such contingencies as the passing of a dividend or a marked decline in the price of one of the stocks in the fund. In some cases the trustee is permitted to sell stocks in order to take profits in a rising market. A stock may be sold, for example, when its price reaches 300 per cent of its price at the date of the formation of the trust. In some cases all stocks must be sold and the trust terminated when the aggregate market value of the stocks in the fund reaches a certain percentage above the value of the stocks at the time the trust was formed.

The holders of shares in the fixed and semi-fixed trusts have little control over the actions of the trustee. Since most of the companies are organized as common-law trusts, the usual relations between the trustee and the beneficiary of a trust prevail. These relations are covered in the trust agreement itself, but in any case the trustee cannot profit at the expense of the trust. If contracts are made with the trust which result in a profit to the management, the contracts can be voided and the trustee required to surrender the profits. If exorbitant salaries or fees are charged by the trustee, the excess over the fair value of the services can be recovered. Relief in equity would probably be granted if the shares in the fund were to be appropriated by persons interested in the management at less than current market prices.[2]

[2] See discussion in *Harvard Law Review,* November, 1930, Vol. 44, p. 117.

The trust agreements sometimes make provision for the certificate holder to voice his dissent from proposed actions of the trustee. For example, when securities are sold, the trustee may be authorized by the trust agreement to invest the proceeds from the sale in securities in an alternate list or in some other stock not in the original or alternate list. In such cases he is required to notify the shareholders of his proposal to invest in such stock, and they may register their objections to the proposal. If the holders of a majority of the shares vote against the plan, the new securities may not be added to the list and the money must be invested in some other stock in one of the original lists. The trustee may, under certain conditions, be required to sell securities at the written request of a shareholder. Modification of the trust agreement may sometimes be made with the consent of a majority of the shareholders. The trust agreement may also be terminated by a vote of a substantial majority of the holders of certificates if the agreement so provides.

4. *The common trust fund.* The common or commingled trust fund is a single trust fund managed by a bank or trust company. It is established by living persons, for their own benefit, each of whom acquires an equitable interest in the principal and income of the fund. The trust agreement usually grants wide powers to the trust company in the investment of the money entrusted to it. The purpose is both income and capital appreciation, but the management is usually more conservative than the average investment company management. A large percentage of the funds are usually invested in preferred stocks, bonds, and mortgages.

Questions

1. Why was the investment company successful in England as early as the 1860's?

2. What principles of organization and management of investment companies were developed in England? Do these same principles appear sound for companies organized in the United States?

3. What was the reason for the organization of investment companies in the United States during the early 1920's? Contrast with the reason for early development in England.

4. What was the basis for the great popularity of investment companies during the boom period of 1927 to 1929?

5. Why did limited management companies increase in popularity after 1930?

6. Why is it unsafe to hold securities for thirty or forty years without any possibility of selling or exchanging them? What types of companies were industrial leaders in 1900? Were the same companies prosperous forty years later?

7. Which types of investment companies are usually organized as corporations? Which types are usually business trusts?

8. What are the advantages of the commingled trust fund? What are the limitations?

9. What is the advantage of the open-end company? Is there any danger that too many security holders might wish to cash in on their securities at the same time?

10. Were American investment companies wise in not purchasing large amounts of securities of foreign corporations and foreign governments?

11. Should investment companies invest principally in common stocks or in bonds and preferred stocks?

12. Should an investment company borrow money on bonds and notes for the purchase of securities or should it be limited to the investment of funds supplied by its own stockholders? What is the danger in the borrowing of funds for investment?

CHAPTER XVI

Practices of Investment Companies and Their Regulation

Most of the investment companies in the United States were organized during the decade of the twenties and the early thirties, and the greatest number were organized in 1928 and 1929. During those years, investment companies were without Federal regulations except for the statute prohibiting the use of the mails for fraudulent purposes, and state control was limited to incorporation statutes and blue-sky or securities legislation. Neither was effective. The stock exchange was then entirely a private institution with no government supervision, and its control was confined to its listing requirements, which also were ineffective. Consequently, many of the investment companies were guilty of very bad financial practices, and they were often used to further the personal interests of their sponsors or managers. One reason for their misuse was the prevalence of the speculative mania which caused speculators to buy securities without adequate investigation in the hope of a profit from advancing prices; but another reason was a belief among many persons, who seemingly were in a position to know better, that investment companies were as closely supervised as banks and insurance companies. The abuses of investment companies eventually made Federal regulation imperative.

I. Abuses of Investment Companies

Many investment companies in the United States have been conservatively managed and have paid satisfactory returns to their security holders, but many of them were mismanaged. The poorly managed companies have largely disappeared through dissolution or merger, and some have passed into the hands of new managers. In the following discussion, therefore, it is not intended to imply that all or even the majority of investment companies have been mismanaged. However, mismanagement has been so general as to create a national problem. The following is a partial list of objectionable financial practices.

Investors were not always given adequate information concerning the policies of their company. While some companies announced a policy of speculating in the stock market, others speculated in the market without stating that this was their policy. In fact, some companies were speculative pools in which stockholders were asked to participate without knowing what securities were in the pool. Many companies published no lists of securities owned and gave no indication of the percentages of their holdings which were represented by common stocks, preferred stocks, or bonds. Frequently the managements of investment companies stabilized the prices of their own securities through purchases and sales in the market without making any announcement that this policy was being followed. Some companies claimed to be buying and selling in the securities markets of other countries when in fact they were trading almost entirely in the American market. Stocks were sold by high-pressure sales methods and by the use of company names resembling the names of well-known financial institutions.

Securities which were unsuited to the investment company were frequently purchased. Investment companies were organized and controlled by bankers, brokers, and securities dealers having interests of their own. The officers, appointed by the sponsors, had only a small investment in the company itself and were willing to work in the interests of those who appointed them. Such companies bought low-grade securities because the sponsors had them to sell. Bankers who were unable to sell a block of securities to the public found a ready market for them in the investment company. Sometimes the investment company joined in the underwriting of a new issue and as a result was required to take a part of the unsold securities. Brokers who controlled a company would have it sell one security and buy another merely to make business for the brokerage house. Some companies made loans to their sponsors at low rates of interest. Securities were bought from favored interests at prices that were out of line with the market.

The securities issued by some investment companies contained inequitable and discriminatory provisions. For example, some of the stock carried multiple voting rights, giving the purchasers of those shares a large percentage of the vote at stockholders' meetings. Warrants entitling the holders to buy more stock at a designated price at any time during the next several years were sometimes issued to favored purchasers. Some groups of stockholders were denied any right to vote at stockholders' meetings or to par-

ticipate in future issues of stock. Stock was generously given to promoters, bankers, and others for their services. Other shares were sold to favored purchasers at low prices. Some stock was later redeemed by the company at prices above the market. To assure that the management of the company would not be held responsible for their wrongdoings, clauses were included in the corporate charters relieving them of all responsibility for losses sustained by the company as a result of their acts.

Many financial devices were used by sponsors to assure their continued control of the company. The use of the usual proxy machinery would in most cases make possible a continuance of control, but if the sponsors thought that this would not make their position secure, they sometimes resorted to business trusts or voting trusts. In the business trust, the shareholders were permanently deprived of voting rights, and in the voting trust they surrendered their right to vote for a period of years. The issuance of two or more classes of securities with only one having the right to vote or with one class having excessive voting rights was also an effective method. The formation of a second corporation to acquire control of an investment company also reduced the amount of stock required to control the investment company. The second corporation, known as a holding company, acquired a controlling interest in the investment company, and the holding company in turn was controlled by the sponsors through ownership of a majority of its voting stock.

Changes in the management of investment companies were sometimes made without stockholder consent. If the management of a company wished to transfer control to others, the transfer was effected by a series of resignations and appointments to the board of directors. One director resigned and his successor was named by the remaining members of the board. A second resigned and his successor was voted in. This was continued until a new board was elected and control was passed to the new group. In some cases control was acquired by purchases of stock in the market. After 1931 many of the companies had little asset value because of the stock market declines, and the purchase of the stock required only a small outlay of cash. New managements frequently made far-reaching changes in policies without the consent or knowledge of stockholders.

Unsound accounting policies were sometimes followed. Securities which had advanced in price were sold, and gains were therefore

reported as income. This was proper because the profits were realized; but losses were avoided by keeping securities which had declined in price and by not reflecting price declines on the accounting records. The gains realized by sale were paid in dividends whereas a part of them should have been kept to offset possible losses on other shares. Stock dividends and stock rights received on stocks owned were sold and the proceeds treated as income although the value of the stocks owned was decreased by such transactions. Dividends were paid from these extraordinary transactions without any indication to stockholders of the nature of the gains. Investment companies which controlled two or more other companies carried out transfers of security investments from one such corporation to the other and recorded the transfers as sales. Profits thus recorded were included in income statements without any indication of the nature of the gains. Such book profits were in fact nothing more then write-ups of investment values. Stock dividends were paid by companies having no par value stock with little or no transfer on the books from the surplus account to the capital stock account. A transaction of this sort is merely a stock split-up, but the stockholder was led to believe it to be a stock dividend. In some cases no distinction was made in the accounts and in balance sheets between surplus which had been paid in by stockholders and surplus which had arisen from earnings.

The accounts and statements of most investment companies were regularly audited by public accountants, but in the absence of regulation by the government many objectionable practices were permitted. It is not to be understood that all companies followed unsound practices, but many of them did so.

Some companies borrowed excessive amounts of money. The ideal policy for an investment company would seem to be to borrow no money, but to invest only the funds supplied by its stockholders. However, if a company could borrow money at a low rate of interest and invest it at a higher rate, it would be able to increase the dividend rate on its own outstanding stock. To illustrate, suppose a company sold $2,000,000 of its own securities, one-half common stock and one-half bonds, and invested that amount in securities of other companies. Its balance sheet would be as follows:

INVESTMENT COMPANY

Investments	$2,000,000	Bonds Payable, 5%	$1,000,000
		Common Stock	1,000,000

If such a company could earn eight per cent on its investments, after expenses, the result would be:

Income on Investments (after expenses)	$160,000
Interest on Bonds at 5%	50,000
Balance for Common Stockholders	$110,000

The company could pay dividends on the common stock at the rate of eleven per cent. The larger the amount raised by bonds, the greater would be the advantage to stockholders provided the company could earn a higher rate on its investments than it pays on the bonds. The difficulty is that in its desire to earn a higher rate than that required for bond interest, the company may make unsafe investments and thus endanger its own solvency.

An investment company which borrows money is called a *leverage company* because the borrowing acts as a lever to increase the earnings on the common stock though the outcome may prove to be the opposite. The bonds issued by such a company are called *face-amount certificates* because the contract calls for the payment of the face amount of the security with interest at a fixed rate.

The objection to the leverage company is twofold: First, the holder of the face-amount security takes a substantial risk since the only assets back of his security are common stocks, yet his rate of return is only that of a bondholder. To be sure, the purchaser of the face-amount certificate entered his contract of purchase voluntarily, but he may not have been fully informed of the policies of the company. He may also be misled by the fact that the security issued to him may be called a bond. Second, the management is tempted to make speculative investments in an effort to earn more than the amount required to pay the interest.

Many companies were organized with inadequate capital. If a company is too small, a large percentage of its income may be required to pay its overhead expense. The result may be the making of speculative investments in an effort by the management to earn a satisfactory net income.

II. Regulation of Investment Companies

It will be impossible to indicate all of the regulations now surrounding investment companies. Under the Investment Company Act of 1940, the Securities and Exchange Commission was given far-reaching powers over such companies. The following is a con-

cise statement of some of the more important provisions under that Act. The listing below follows the order of the foregoing list of abuses.

Full publicity of investment policy is now required. Any investment company which sells securities in interstate commerce is required to register with the Securities and Exchange Commission. The registration statement must include a copy of the corporate charter or, in the case of business trusts, the deed of trust; and it must indicate the investment policy of the company. It must describe the securities to be issued and the rights and privileges of each, and the borrowing or lending operations contemplated. It must give the names and business connections of the officers and investment advisers. Speculation in securities, if such is the policy, must be in accordance with rules and regulations prescribed by the Commission.

An investment company cannot be under the control of other interests. It must have a board of directors no more than sixty per cent of whose members are investment advisers. It cannot employ a broker, an underwriter, or an investment banker if such persons and those affiliated with them constitute a majority of the board. No investment company is permitted to have a majority of its directors affiliated with any one bank unless they were appointed prior to March 15, 1940. It can underwrite securities only in relatively small amounts stated as percentages of its total assets. It is not permitted to enter the insurance business or the brokerage business. Its investment advisers must be selected by vote of its shareholders. Loans by the company to any persons are subject to regulation.

The issuance of securities is regulated. Closed-end companies cannot issue securities for services, and stockholders cannot be denied the preëmptive right. Warrants cannot be issued by management companies if the expiration date of the warrants is more than 120 days from the date of issuance, and all warrants must be issued exclusively and ratably to stockholders. These and other similar provisions are designed to prevent one group of security holders from having an unfair advantage over another.

The right of stockholders to control their company is safeguarded. No investment company can acquire control of another unless it previously owned twenty-five per cent of the stock. The soliciting of proxies must be in accordance with rules and regulations prescribed by the Commission. Mutual control of two com-

panies is prohibited through the provision that the two companies cannot invest in each other's stock in amounts of more than three per cent.

Changes in investment policy or in control must have stockholder consent. The investment policy as stated in the registration statement cannot be changed unless the change is authorized by vote of a majority of the outstanding voting securities. Directors must be elected by the stockholders at a special or annual meeting. If vacancies in the board occur between annual meetings, the remaining directors can fill the vacancies provided two-thirds of the directors have been elected by the stockholders. If further vacancies occur, they can be filled only at a special or regular meeting of the shareholders. If the company is organized as a business trust, vacancies can be filled in any manner prescribed by the trust agreement, but the beneficiaries or holders of the trust certificates must be given the right to remove a trustee by a two-thirds vote.

Accounting practices are subject to review by the Commission. The Act states that dividends can be paid only from undistributed net income which is not to include the profits from the sale of securities or other properties, unless the payment is accompanied by a written statement adequately disclosing the source of the income. Adequate accounts and records are required to be kept, and they are subject to examination by the Commission. Financial statements must be signed or certified by public accountants who have been selected by the directors and ratified by the stockholders (except in the case of business trusts). Accountants and auditors are required to keep reports and worksheets showing what they did in the course of the audit. The worksheets are subject to examination by the Commission.

Excessive borrowing is prohibited. Closed-end and open-end companies can borrow only if there is an asset coverage of 300 per cent for the bonds or other liabilities. This means that the value of the assets must be three times the amount of the liabilities. The maximum amount of borrowing would be as shown in the following condensed statement:

REGISTERED INVESTMENT COMPANY

Securities Owned	$900,000	Bonds Payable (maximum)	$300,000
		Common Stock	600,000
Total Assets	$900,000	Total Bonds and Stock	$900,000

If preferred stock is issued, it must have an asset coverage of at least 200 per cent. If the company referred to in the preceding illustration issued bonds and also preferred stock, the maximum amount of preferred stock would be $150,000. Its balance sheet would be as shown in the balance sheet below:

REGISTERED INVESTMENT COMPANY

Securities Owned	$900,000	Bonds Payable (maximum)	$300,000
		Preferred Stock (maximum)	150,000
		Common Stock	450,000
Total Assets	$900,000	Total Bonds and Stock	$900,000

If, as a result of losses, the asset coverage should fall to less than the specified percentages, the company cannot pay dividends (other than stock dividends) or repurchase its own stock until the deficiency has been made up. If preferred stock dividends are unpaid for two years, the preferred stockholders must be given the right to elect a majority of the directors until the dividends in arreas have been paid.

The minimum size of certain types of companies is prescribed. A company issuing face-amount certificates cannot be organized unless its outstanding stock at a fair valuation of its assets will be at least $250,000. No registered company of any type can make a public offering of securities unless it has a net worth of at least $100,000, or unless it has previously made a public offering of securities and at the time of the earlier offering had a net worth of $100,000 or more. These provisions are designed to prevent the formation of companies which are too small to operate efficiently. A similar purpose appears in the provision that if securities are paid for by a periodic payment plan, the sales load cannot exceed nine per cent.

The foregoing provisions serve to indicate the detailed nature of the provisions of the Investment Company Act of 1940. It may seem to be another case of making the regulations too late, but much can be done to insure sound management of companies now in existence. In time, we may experience another era of promotions and security speculation which would result in a repetition of the abuses of the decade of the twenties unless regulation is instituted in advance. Since the law was enacted in 1940, a relatively small number of promotions have been carried through for the reason that most of the savings of the country have gone into war bonds. It

will probably require a period of peacetime investment to determine how effective the legislation will be.

Questions

1. If an investment company selects its securities for investment by maintaining an elaborate research staff, should it make the list generally available by supplying the information to stockholders?

2. Should an investment company speculate in the stock market? Why did the public buy the securities of companies which were known to use a large percentage of their funds for stock speculation?

3. What groups of persons sometimes obtained control of investment companies? Show how each could use the company to its own advantage.

4. Why did some companies adopt names resembling the names of well-known financial institutions? Why did the institutions not object?

5. What is a stock warrant? Why is it objectionable? Why was it used by investment companies?

6. How did the sponsors of investment companies retain control with little or no investment in the company?

7. How was control of investment companies transferred? For what purposes was control transferred?

8. What disposition should an investment company make of profits realized on the sale of securities? Why?

9. Are stock dividends income to the recipient? Why? Should stock dividends received be shown in the income statement of the investor who receives them?

10. What is the difference between a stock dividend and a stock split-up?

11. If the statements of investment companies were regularly audited by public accountants, why were bad accounting practices not prevented?

12. What is a leverage company? Why is it objectionable?

13. Should an investment company be permitted to borrow money for investment purposes?

14. How large should an investment company be?

15. What information is contained in the registration statement of an investment company?

16. Should the Securities and Exchange Commission have authority to prescribe the procedure to be followed by an accountant in the auditing of investment-company statements?

17. How much money is an investment company permitted to borrow?

18. Why should the Federal government concern itself with the regulation of investment companies? What provision in the Constitution gives it the authority to do so?

PART FOUR

Industrial Combination

CHAPTER XVII

Trade Associations

A trade association is a non-profit organization of independent business concerns in the same industry or trade. A trade association does not conduct any business on its own account, but it attempts to promote the interests of its members. Since the members are usually competitors, the promotion of their interests may take the form of a restriction of competition between them; but the association may also attempt to assist the members in many other ways, such as finding new uses for the product, advertising the product of the industry, or assisting in the reduction of manufacturing costs.

I. The Organization of the Trade Association

Some trade associations are national in scope while some are sectional or local. Sectional associations limit their membership to the businesses in a section of the country, such as New England or the Middle Atlantic States. Some associations limit their membership to a single state, and others limit it to a certain city or locality, such as Greater New York; a few associations include members in Canada and therefore are international. Whatever its territorial scope, the trade association differs from general business associations which include manufacturers or producers from more than one industry, such as chambers of commerce, boards of trade, and general manufacturers' associations.

Some trade associations are horizontal, and some are vertical. A *horizontal* association is one which limits its membership to producers specializing in the same stage of manufacture. The members of such an association are competitors. The *vertical* association admits businesses which are producing and handling a product at

successive stages of production or distribution. Some associations include in their membership representatives from every group of producers, from the manufacturer of the raw materials to the retailer. Many manufacturers' associations admit either wholesalers, through whom the product is distributed, or the producers of raw material, without admitting producers and distributors all along the line.

Since some trade associations are vertical and some horizontal, and since many manufacturers produce more than one article, it frequently happens that a manufacturer is a member of two or more associations. This is particularly true of manufacturers in such industries as hardware and chemicals. The result is a certain amount of overorganization and duplication of effort—which is probably one reason for the heavy mortality of trade associations.

The organization machinery is relatively simple. At the annual meeting of the association, the members elect a board of directors or trustees, which usually numbers from ten to thirty. The board is large enough to give representation to various interests in the membership but small enough to constitute a compact and workable body. The directors select officers and supervise the affairs of the association. They may appoint committees to investigate special problems.

The usual officers are a president, a vice-president, a treasurer, and a secretary. The secretary does most of the detailed work and is often the only salaried officer. Much of the success of the association depends upon him. The president is the chief executive officer. He presides at meetings of the board and annual meetings of the association.

The work of the association may be made to conform to the needs of the industry by the creation of divisions of the membership. The divisions may be geographical or functional. For example, the buyers, accountants, or technical men may be organized as subordinate divisions for the discussion of special problems.

Trade associations may be incorporated or unincorporated. Trade associations do not need to incorporate to sell stock, but some of them are non-stock corporations. Expenses are met from dues and assessments. Some have flat membership dues, while others vary the charges according to some scheme which is supposed to measure ability to pay or benefits received. Some vary the assessments from year to year according to the needs of the budget.

II. The Trade-Association Movement

The trade-association movement began about 1850. One of the earliest associations was the American Brass Association, formed in 1853. Since the manufacture of brass products was confined largely to Connecticut, this association was not national in scope. The association proved to be short-lived. It soon attempted to increase prices and to apportion production to its members, but it found that it was unable to control its members indefinitely. With the break-up of the price pool, its influence gradually declined.

One of the first permanent associations was the Hampton County Spinners Association, formed in 1854. This association limited its activities to a study of the technical problems of manufacture and the exchange of trade information between the members. In 1865 the local association became a sectional trade association, and in 1894 it became a national trade association under the name of the National Association of Cotton Manufacturers.

The American Iron and Steel Association, another permanent trade association, was formed in 1855. Later it became a part of the present American Iron and Steel Institute. Throughout its history this organization has rendered valuable service by tabulating and publishing statistics of production, of prices, and of shipments for the iron and steel industry.

Trade associations became important during the post-Civil War period. During the Civil War period a number of new associations were organized, and the movement received great impetus during the prosperous years from 1871 to 1873. One of the principal activities of trade associations during the years following the Civil War was the regulation of prices. This was often accompanied by the limitation of production, the division of markets among the members, or some other agreement to insure that each member would receive his share of the profits of the industry. These agreements were usually of short duration because of the inability of the association to control its members and to require the observance of the agreement.

The character of the trade association changed after 1890. Many associations attempted to build up a spirit of coöperation and to better the conditions of the industry. They held annual meetings, the proceedings of which were published. Some established permanent headquarters and carried on continuous activities. Many of them undertook for the first time such work as the grading and

inspection of the product and the compilation of statistics of prices, production, and stocks on hand. Credit rating bureaus were established. Coöperative advertising was undertaken.

After 1912 many trade associations developed open-price agreements. The object of the open-price agreement was to provide for the interchange between the members of information pertaining to the volume of production in the industry and the current price for the product being charged by the various producers. In addition to information as to prices and production, many trade associations compiled statistics covering bids made on contracts, orders, shipments, purchases, production and selling costs, and stocks on hand. The members could use this information to prepare their own production schedules and their price lists. The trade associations explained that the compiling of this information was not to restrict competition but to give to the members as complete a knowledge of the market as possible.

The idea of the open-price agreement has been credited to Arthur J. Eddy, a Chicago lawyer. His views were stated in his book, *The New Competition,* published in 1912. Mr. Eddy argued that the manufacturer should have a single price for his product and that information as to prices should be available to all buyers and sellers alike. If this were done, prices would become more stable because the market would be made free and open. Mr. Eddy thought that this plan would not be contrary to the antitrust laws, for the avowed purpose would be to improve trade conditions and there would be no agreement either expressed or implied, no moral obligations, no penalties, and no gentlemen's understanding. He declared that manufacturers have the right to publish prices, to exchange bids freely and openly, and to deal frankly with customers and competitors. The open-price plan was immediately adopted in several industries.

Trade associations grew rapidly during the First World War. When the United States became involved in the war in 1917, the demand for war supplies exceeded any previous demand. The government encouraged industries to form trade associations in order that there might be effective use of raw material and also control of prices. Under the supervision of the government, trade associations compiled detailed information pertaining to industry, such as the capacity, the volume of output, the location of factories, and the names of the owners. The information was of great assistance in planning for war production.

Trade associations increased in importance after the war. The growth of trade associations after the war was due in part to continued support by the government. The Department of Commerce was particularly interested in their statistical work. In 1921 it began the publication of the *Survey of Current Business,* in which many series of business statistics are published. The information is intended especially to aid small businesses which are not members of trade associations, though much of the data is compiled originally by trade associations.

Trade associations assumed an added significance under the National Industrial Recovery Act of 1933. That Act encouraged trade associations to draw up codes of fair competition and to present them to the government for approval. Industries were also encouraged to organize trade associations for the purpose of drawing up and enforcing the codes. After the Act was declared unconstitutional in May, 1935, trade-association membership declined slightly, but by the end of 1936, it was greater than ever before.

Labor relations and price-control legislation have received increased emphasis by trade associations in recent years. The guarantee of the right of labor to organize and to bargain collectively which was embodied in the Wagner Labor Relations Act has required employers to devote more attention to employer-employee relations of the individual company and also of the industry as a whole. Trade associations have attempted to assist members by studying the problem and by encouraging the discussion of methods of organizing labor relations. They have been active in securing legislation permitting manufacturers to prescribe the retail prices of their products and prohibiting sales below cost. Associations also aid in policing their industries to see that the laws are obeyed.

The trade-association management company is of recent development. During the decade of the thirties, management companies began to assist associations in gathering and disseminating trade statistics, and also to take over other phases of trade association management. One management company may administer the affairs of two, three, or more associations. The management company usually specializes in statistical work, such as designing the form of reports, collecting the information, compiling the reports, and supplying the information to members. Management companies have also been of service in the standardization of the product of the industry and the reduction in number of styles, sizes, or

designs of product manufactured. Many trade associations have accomplished much the same objective by forming federations of associations for joint management. Such federations employ specialists to aid the members of the industry in dealing with special problems.

During the Second World War many activities were discontinued and new activities were undertaken. The shortage of manpower during the war forced trade associations to shift their men from some activities which were not essential to those activities more directly connected with the war. Activities discontinued included credit reports, monthly bulletins, field work, and statistical services. Among the activities which were initiated or expanded were the following:

1. Comprehensive bulletin service covering government orders and regulations. The members were kept informed of regulations concerning rationing, priorities for materials, wages and hours, manpower, and ceiling prices.

2. Assistance in the procurement of materials and the development of new sources of materials.

3. Promotion of war themes in advertising and coöperation with government agencies in radio broadcasting in support of rationing programs, war loans, and in other ways.

4. Coöperation with the government in the preparation of questionnaire and report forms.

5. Surveys of the productivity of labor, the numbers of workers available in an industry or area, and labor shortages.

6. Advice to members on conversion to war production and later to peace production. Trade associations aided members by expediting decisions and by gaining exceptions to war regulations which would have caused hardship in individual cases.

7. Assistance to members in getting contracts and in handling problems arising out of such contracts including renegotiation and termination. Many associations assisted members in obtaining priorities for materials and in getting answers to questions concerning contracts.

8. Seeing that the products of the industry, such as concrete pipe, were permitted or required by the specifications for construction or other contracts.

9. Assistance in postwar planning in coöperation with government agencies and in compliance with government regulations.[1]

The number of trade associations at present is about 12,000. Approximately 4,000 are local in scope, and many others are sectional or state-wide. The number of national or international associations is about 1,200, of which about 800 are associations of manufacturers.

III. Prices, Trade Statistics, and Costs

The work of trade associations in so far as they relate to the dissemination of trade statistics and the installation of uniform cost systems may best be considered together, since these various activities are closely related. Most associations which compile and publish information pertaining to prices also disseminate statistics of production, orders received, and shipments of goods.

Trade associations engage in various types of price activity. The most common form of open-price activity is the exchange of price lists. In some cases the exchange is made directly between the members without the use of the facilities of the association. Some associations exchange information concerning prices on specific contracts while others convert the figures into averages. In the case of commodities having a local market, such as bricks and cheap furniture, the price information shows merely the high and low prices for various districts in the United States. Some associations make the price information available to one desiring it, but some supply it only to members.[2]

Trade associations have several purposes in disseminating price information. It is usually the hope of the members that price information may result in greater stability and a smaller range in prices. Conditions in the industry may be improved in the following ways:

1. Members who do not have a cost system may gain an idea of the probable cost in various lines of goods through the general level of prices.

2. Producers are placed in a better position in meeting the tactics of buyers. Buyers may be expected to shop around and to secure

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[1] W. J. Enright: "Trade Groups Do a War Job," *Nation's Business,* May, 1944.

[2] For discussion of price reporting, see L. S. Lyon and Victor Abramson: *The Economics of Open Price Systems.* Brookings Institution, Washington, 1936.

bids, and the prospective buyer is therefore in a strategical position to play one producer against another. If the producers are informed as to the prices prevailing throughout the industry, their bids may be more intelligently made. Manufacturers say that buyers frequently try to deceive sellers by quoting fake bids and that price information puts buyer and seller in more nearly equal bargaining positions.

3. Where average prices are reported, all members may attempt to charge at least as much as the average. Manufacturers may also use average prices to indicate the general trend throughout the industry.

Price information is usually supplemented by other statistics. If the members of the association are to forecast intelligently the future trend of prices within the industry, they must know approximately the volume of goods being produced for the market, the plans of manufacturers for future production, and the probable demand for the product. The association cannot supply all of this information, although it can and often does supply some of it. The information most commonly supplied, in addition to the price information, includes volume of production, unfilled orders, and shipments. In some cases data are supplied also concerning the productive capacity of the industry, orders received, quotations or bids for contracts, and cancellations of orders. Figures both in volume and in dollars may be reported for orders received, cancellations, unfilled orders, and shipments. The details of the reports vary from industry to industry. Some statistics are reported weekly, some biweekly, some monthly, and some quarterly.

Statistics of the industry are helpful in stabilizing business conditions. Trade statistics are of value in the following respects:

1. Data showing unfilled orders enable the producer to gauge the probable output of the industry during the ensuing months. The unfilled orders in any particular month or year depend in a large part upon the practice of customers in ordering in advance or in buying "from hand to mouth."

2. Data for accumulated stocks are a gauge of the ability of the industry to meet current demands. An increase or decrease in stocks is particularly significant, though allowance must be made for seasonal fluctuations.

3. Statistics of the volume of shipments are an index of the rate

at which goods are moving into the hands of consumers. If shipments fall off but production continues, the result is reflected also in the figures for accumulated stocks.

4. Statistics of productive capacity may prevent unwise duplication of plant and equipment.

5. Information concerning industries from which a company buys or to which it sells may be utilized in formulating buying and selling policies.

Many trade associations have undertaken the work of designing uniform cost-accounting systems. In designing and installing uniform accounting systems, the trade associations have had the precedents set for them by the Interstate Commerce Commission for railways and by utilities commissions. Uniform cost systems vary from a chart of accounts to complete systems including forms and procedures. The cost of installing a system may be met in any one of several ways. Some associations have arranged a scale of dues which permit of a certain amount of work without additional charge. Some make special assessments to cover the cost, while others require that each member using the system pay the accountant who installs it.

One purpose of a uniform system is to insure that each member has accurate cost information. Regardless of uniformity, the association is interested in having each member obtain adequate cost data. The advantage of the system provided by the trade association is low cost. Since the problems of cost accounting are similar for all plants in an industry, a system designed for one plant may with modifications be used in another.

A second purpose of a uniform system is to make competition more intelligent. Many manufacturers have no cost system, and others may compute costs in different ways. Uniform systems are intended to inform members of what their costs really are and to remove price-cutting which may result from lack of knowledge of costs.

A third purpose is to enable each member to compare his costs with the costs of others. A comparison of costs is made possible by exchange of cost information through the facilities of the trade association. Cost information may be converted into averages, such as average material, labor, and expense cost per unit of product. The figures may be stated in dollars and cents or in percentages of the total costs. Comparison of cost information presupposes a

uniform system of accounting. Otherwise, the cost figures would not be comparable.

A fourth purpose may be to bring about uniform selling prices. If the average costs of all or a large percentage of members in an industry are made available to each member, the cost figures may be made the basis for selling prices. The mere dissemination of cost information usually results in a greater uniformity of prices. However, the use of cost information for price-fixing is illegal.

IV. Other Activities of Trade Associations

Trade associations carry on many activities. Some of them have been mentioned earlier in this chapter in connection with the discussion of the development of trade associations and require no further discussion. The following enumeration is suggestive but is not intended to be exhaustive.

Many associations regulate competitive practices. Trade associations attempt to raise the level of competition by prohibiting the use of certain unethical or unfair practices. The methods objected to vary from year to year and from industry to industry. Among them are bribery of the purchasing agent of a customer in order to make a sale, bribery of the sales manager of a vendor in order to procure supplies, misbranding of the product, misleading advertising, disparagement of the products of a competitor, threats of suit for patent infringement, discrimination between customers in the granting of rebates and discounts, imitation of the trade-marks of competitors, and inducing employees of a competitor to violate their contracts of employment. Unfair methods of competition are illegal under the Federal Trade Commission Act of 1914, and in many cases the work of trade associations is educational in nature.

Trade associations frequently concern themselves with employee relations. During their early history, many trade associations were charged with making the struggle against labor unions their principal activity. Since 1933, the belief that collective bargaining has come to stay has been gaining, and many trade associations have turned to the problem of employee relations. Some associations have attempted to build up principles and methods of negotiating with employees in order to avoid or minimize the effects of labor troubles. They have encouraged employers to deal with employees in such a way that labor feels that it is getting a fair deal and does not need to organize. In other industries, associations

have recognized that the majority of their plants were unionized and have assisted employers in negotiating with labor. Industrial surveys have also been undertaken in order to determine what various employers are doing to maintain proper labor relations, what the level of wages is, what labor difficulties face the industry, and what policies should be followed by the industry and the individual employers.

Trade associations have made great contributions toward standardization and simplification. Standardization has to do with drawing up specifications for grades, sizes, structure, and composition of a product or the raw material, including the limits of tolerance. Simplification means the reduction in the number of grades, sizes, or styles of the product and the containers in which the product is shipped. Simplification is a natural result of standardization, and the simplification movement has grown out of the standardization movement. Standardization and simplification is, of course, a coöperative undertaking. The government exercises an important influence in initiating and advising about the work. During the Second World War, it required the elimination of many styles or types of product and also of many parts or accessories.

REDUCTION IN SIZES AND STYLES BY SIMPLIFICATION

Commodity	*Formerly*	*New Sizes, etc., Agreed Upon*
Common bricks	44	1
Paving bricks	66	6
Plow seats	12	1
Metal lath	125	44
Woven wire fence	552	62
Roofing slate	98	49
Grinding wheels	715,200	254,400
Steel barrels and drums	66	25
Shotgun shells	4,067	343
Paper, grocers' bags	6,280	4,700
Milk-bottle caps	10	1

The amount of saving to industry through standardization and simplification is variously estimated, but it undoubtedly is very large. Some of the notable successes are shown in the accompanying table.[3] The figures given are only illustrative, however, since the sizes and varieties of a product offered are studied anew by trade associations each year, and lines are added or withdrawn from time to time as experience indicates the desirability of change.

[3] Compiled from publications of the Bureau of Standards.

Many associations maintain inspection services to enforce the standards set up for the industry. When goods are bought on a contract which states the specifications of the materials, the trade-association inspector will inspect the shipment for the member. If the materials meet the requirements prescribed by the association, the inspector will issue a certificate to that effect. The association inspectors frequently are called upon in case of disputes between members and purchasers. Inspection services are maintained by a number of trade associations in the lumber industry, including the Maple Flooring Manufacturers Association and the Southern Pine Association.

Some trade associations aid in traffic problems. Among the traffic problems that may be conveniently and economically handled by trade associations, are changes in freight rates, in the freight classification involving products of the industry, and sometimes in freight claims. Some associations limit their traffic activities to keeping members informed of rate changes. As might be expected, the associations most interested in traffic problems are in those industries producing bulky products for which the freight charge is a large percentage of the final cost, such as the lumber and canning industries and parts of the metal industries. Some associations are interested in traffic problems principally for the purpose of assuring the proper packing of shipments and the prevention of damage to goods in transit.

Credit information is another trade-association activity. This service consists in the collection of information pertaining to the credit standing of dealers with whom the members of the association do business. A member desiring credit information makes his request to the secretary. If the information is already in the file, it is supplied at once; if it is not in the file, the other members are asked to make reports on the dealer concerned, and the information is supplied in answer to the inquiry. Many associations do not provide credit service, but some consider it their most important activity. Some supplement it with a collection service. The exchange of credit information is legal unless it is accompanied by a black list.

Coöperative advertising is sometimes conducted by trade associations. One object of coöperative advertising is to ward off the competition of other products, such as various types of building materials. Another purpose is the overcoming of a particular type of consumer resistance, such as a belief that canned goods are not

wholesome or that margarine is lacking in vitamins or food values. During the Second World War, the dairy interests advertised extensively in an effort to overcome the effect of high ration-point values on butter in comparison with margarine. A third type of trade-association advertising is directed to the introduction of a new product, such as canned grilled hamburgers, dried milk, dehydrated vegetables, air-conditioning equipment, and steel houses.

A fourth type of coöperative advertising is designed to increase the general use of the product of the industry. The National Paint, Varnish and Lacquer Association has conducted "clean up and paint up" campaigns in thousands of communities, enlisting the coöperation of local business and civic organizations in an activity which substantially increased the demand for paint. Similar campaigns have been conducted by such industries as accordion and guitar manufacturers, ice-cream manufacturers, and hardware stores.

Coöperative advertising is conducted most extensively in those industries in which goods are produced by small business units for a wide market. Large companies can best do their own advertising under their own names. If the market is limited in area, the small manufacturer may successfully advertise within his own market. Some advertising is directed to the ultimate consumer, some to the retailer, and some to the wholesaler or jobber.

Trade associations frequently sponsor legislation regulating the industry. One method of controlling the trade practices of an industry is to enlist the sanction of the law behind the program. Legislation which trade associations have sponsored include taxes on chain stores, the prohibition of sales below cost, pure food and drug laws, laws prohibiting the use of certain materials in manufacture for sanitary reasons, curbs on itinerant vendors and street peddlers, and freight rate and tariff revisions. Agitation for legislation desired by the industry is a common phase of trade association activity.[4]

Many other activities are occasionally conducted by trade associations. The following are suggestive of the varied activities which associations may conduct:

1. *The maintenance of employment offices for the industry.*
2. *Research in improved methods of manufacture.* Associa-

[4] For discussion of all phases of trade association work, see T.N.E.C. Monograph No. 18: *Trade Association Survey.* Washington, 1941.

tions have carried on research in the meat-packing, canning, paint, and laundry industries.

3. *Regulation of relations with the trade.* Some associations have adopted regulations concerning returns of merchandise by customers, discounts and datings of invoices, and credit ratings.

4. *Coöperative buying.* This is an important activity of many local associations.

5. *Exchange of machinery and materials.* Any member having machinery or materials in excess of his needs or not suited to his use may sell or trade them through the offices of the association.

6. *Mutual fire and casualty insurance.*

7. *Public relations.* Many trade associations attempt to influence public attitude toward the industry by disseminating information. During the Second World War when the facilities of many industries were largely or fully utilized in war production, trade associations undertook to inform the public of the services being rendered to aid the war effort.

8. *Reduction of traffic accidents.* This has been an important feature of the work of the Automobile Manufacturers Association, the American Trucking Association, and the International Association of Milk Dealers. Safety programs within plants have been promoted by associations of meat packers, cement manufacturers, coal mining companies, and other groups.

9. *Coöperation with producers of raw materials.* The National Association of Food Chains has organized a number of sales campaigns featuring certain agricultural products. These sales have established a better relationship between the farmer and the food chains and have improved the public relations of chain stores.

10. *Educational programs.* Programs of study usually provide for the training of dealers or others who sell or use the product. Thus, the trade association in the anthracite coal industry offers a five-day course for coal dealers in basic heating principles, anthracite-burning equipment, and sales and merchandising methods. The New Jersey Laundryowners Association offers a course for its members that includes washroom methods and textiles, merchandising, training for foremen, and sales-analysis methods. Similar educational programs are conducted by the American Institute of Banking, the American Bakers Association, and the Heating, Piping and Air Conditioning Contractors National Association.

Questions

1. What is a trade association?

2. What is an industry? Is automobile tire manufacturing a part of the rubber industry or the textile industry? Is it a separate industry?

3. Distinguish a vertical trade association from a horizontal trade association.

4. What are the usual officers of a trade association? What are their duties?

5. What are the reasons why trade associations began to be formed about 1850? Do you see any relation between the organization of trade associations and such developments as the introduction of machine methods of manufacture, the building of railroads, the development of new industries, the increase in overhead manufacturing expense due to fixed investment in plant, and the greater territorial expanse of markets?

6. How did the character of trade-association activities change during the years 1890 to 1910?

7. What was the purpose of the open-price plan as developed by Arthur J. Eddy?

8. What did trade associations do during the First World War to assist the members and the government? What did they do immediately after the war?

9. What was the principal work of trade associations while the National Industrial Recovery Act was in force?

10. What is the work of the trade-association management company? Why can such work be done most effectively by someone outside the association?

11. How were trade association activities changed during the Second World War?

12. How are statistics of an industry expected to stabilize conditions? What are the limitations of such statistics?

13. What are the purposes of uniform cost-accounting systems?

14. Does a trade association need to concern itself with a competitive practice if it is illegal? Why not let the government correct the practice?

15. A manufacturer finds that he is making so many sizes, styles, and colors of product and is making so many products on specifications supplied by customers that his profit is small. Can he correct the situation alone? How should he proceed?

16. What is a black list? Might it be used as a means of controlling price cutting? Might it be a weapon against labor unions?

17. What industries might profitably conduct coöperative advertising?

18. Is the sponsorship of legislation by trade associations socially desirable? Is this the same thing as lobbying?

19. What activities of trade associations may be illegal?

CHAPTER XVIII

Gentlemen's Agreements

The gentlemen's agreement is *a restrictive agreement enforced by moral sanctions.* It is a loose and decentralized form of combination which leaves the owners in control of their businesses but imposes limitations upon their freedom of action with regard to certain policies, such as the volume of production, prices, or markets. Such agreements are not expected to be permanent. They are not written, but the terms are either orally agreed upon or tacitly understood. No penalties are imposed, but each party is placed upon his honor to carry out certain policies.

Three forms of gentlemen's agreements may be distinguished: (1) agreements providing for a division of markets, (2) simple price agreements, and (3) the basing-point system of pricing. The basing-point system is not always a form of gentlemen's agreement, but it may be the basis of a secret understanding as to prices for the products of the industry.

I. Agreements for the Division of Markets

A simple form of gentlemen's agreement for the division of markets is an understanding between two manufacturers that neither will send salesmen into the other's territory or that neither will manufacture an article which the other has been making and selling. This sort of agreement ranges from a tacit understanding to a complex agreement with an organization to enforce the provisions of the agreement. The more complex forms are classified as pools, and will be discussed in a later chapter.

Markets may be divided territorially. An understanding for the territorial division of markets is believed to have existed for many years in the oil industry. Prior to 1911 the Standard Oil Company of New Jersey and its subsidiaries had a virtual monopoly of the sale of kerosene and gasoline in the United States. It divided the United States into marketing territories, and assigned each sub-

sidiary to a territory. In only one case did the territories of the various companies overlap. In most cases the boundaries of the territories were determined by the size of the refineries and the cost of transportation; in a few the territories followed state lines, as was true, for example, of the Standard Oil Company of Nebraska, which was assigned the entire state of Nebraska.[1] In 1911, when the Standard Oil Company was dissolved as a result of a suit under the Sherman Antitrust Act, it was required to distribute the stock of its subsidiary corporations among its stockholders. At the time of the dissolution, however, each subsidiary had an established business in its territory and did no business outside that territory. Since that time each company has for the most part refrained from entering the territory of the others.

In recent years a few of the Standard companies have entered the territories of other companies. In addition, a number of oil companies that were not of the original Standard group have entered the field and have built up marketing systems alongside the old Standard companies. The largest of the independent oil companies are the Texas Company, the Gulf Oil Corporation, and the Sinclair Oil Company. The Standard companies still do such a large percentage of the business, however, that they are in most cases able to establish the price of oil for all companies; this is accomplished through a policy of price leadership, the independents simply following the prices fixed by the Standard company.[2]

Markets may be divided by products. To eliminate price competition, two or more companies may by mutual agreement refrain from manufacturing a new product to compete with a product of the other in its established field. Thus, each company maintains its position in the marketing of a product. For example, for many years one prominent manufacturer of soap refrained from producing a vegetable shortening to compete with the product of another company in return for a free field in the manufacture and sale of a certain kind of soap.[3] At one time a similar agreement left the production of iron pipe to one steel company and of other types of fabricated steel to others.

Markets may be divided by customers. By tacit agreement,

[1] Federal Trade Commission: *Prices and Competition in the Petroleum Industry*, p. 68, 1928.

[2] T.N.E.C. Monograph No. 21: *Competition and Monopoly in American Industry*, p. 128, 1940.

[3] *Time*, June 22, 1942, p. 76.

companies may refrain from soliciting or even accepting business from the customers of each other. By force of tradition, each may continue to hold its customers, and the customers may continue to offer their business to the same vendor. To illustrate, in the marketing of stocks and bonds, it has long been the practice for the issuing corporation to offer the securities to the same investment banker. When a new issue is to be sold, the price is fixed by the bank without competitive bidding from any other bank. In some cases, though not in all, the explanation may be found in an affiliated relationship, with either common directors or common stockholders between the issuing corporation and the bank. Under regulations promulgated in accordance with the provisions of the Public Utility Act of 1935, public-utility corporations are not permitted to sell a new issue of securities on the basis of private negotiation with the banker but must seek competitive bids.[4] Since 1944, a railway corporation is required to sell its bonds through competitive bidding. Industrial corporations have also, on occasion, sought competitive bids in the sale of their securities in violation of the general rule.

II. Agreements as to Prices and Production

Some gentlemen's agreements relate to prices only, but most of them include sales and production policies. Unless the agreement results in a restriction of the volume of output or some apportionment of the business between the members, the agreement is usually ineffective. Those members who believe that they are not getting their share of the business are likely to violate the agreement and either reduce prices or offer the customer some concession as to the terms of sale. As soon as some members suspect that others are cutting prices, they meet the price reductions and the effectiveness of the agreement is at an end. This situation may be avoided by the control of output as well as prices.

Gentlemen's agreements are sometimes merely a tacit agreement to follow the prices fixed by a leader. If one company has a predominating position in an industry, it may establish its prices with the understanding that other companies will charge the same prices. No formal or informal agreement may be made. This has been the practice in the steel industry for many years where the

[4] Securities and Exchange Commission: *Annual Report*, 1941, p. 99.

United States Steel Corporation is the leader. In the cracker industry, leadership is assumed by two companies, the National Biscuit Company and the Loose-Wiles Biscuit Company. The price of cheese has long been fixed on the board of trade at Plymouth, Wisconsin, where only a small part of the national output of cheese is actually sold.[5] The price fixed there is followed by tacit understanding. Other industries where prices are fixed by price leadership are cement, agricultural implements, gasoline, copper, lead, newsprint, paper, plate glass, and glass containers.[6]

Price leadership is most effective where the product is standardized and not sold under trade names, where sales are at delivered prices, and where a few well-informed producers dominate the industry.[7]

Producers may bring moral pressure upon other manufacturers to maintain established prices. For example, the Empire Association of Stove Manufacturers once followed a policy that was designed to bring price-cutters into line. The association put certain styles of stoves on display, and to each stove was attached a card giving the average selling price for all members. The price was computed after making allowance for all extra parts, such as oven racks, shelves, and special door attachments. At a meeting of the association, a committee interviewed each manufacturer whose selling price was below the average and asked him to explain why his stove should sell at a low price. The association contended that the work was educational and that no pressure was brought upon any individual to increase his prices. An association of flour manufacturers asked its members to write or telephone other millers who were reported to be reducing prices. The avowed object of this policy was to prevent buyers from playing one miller against another. A trade association of manufacturers of corn products required members to file their prices with the association and to report by telegraph any deviation. Members who sold for less than the scheduled prices were questioned by telegraph and by mail and also were asked for explanations at annual meetings of the association.

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[5] T.N.E.C. Monograph No. 21: *Competition and Monopoly in American Industry,* p. 142, 1940.

[6] *Ibid.,* pp. 121-131.

[7] See George P. Comer: "Price Leadership," *Law and Contemporary Problems,* Vol. VII, pp. 61-73, 1940.

III. Basing-Point Systems

In the steel industry and some other industries, price leadership has been made effective through a basing-point system. This system is the practice of pricing the product on a delivered basis. The price of the product delivered to the place of business of the purchaser is the price at a certain basing point plus the freight. This practice does not necessarily result in a gentlemen's agreement, but it may do so. Two forms of basing-point systems are in use: (1) the single basing-point system, and (2) the multiple basing-point system.

The single basing-point system provides for only one shipping point as the basis for pricing. When a single basing point is used, the price of the product delivered to the customer is the price at the basing point plus the freight. For example, when this system was used in the steel industry, the basing point was Pittsburgh, and the price of steel delivered anywhere in the United States was the price at Pittsburgh plus the freight from Pittsburgh. When the price at Pittsburgh, for example, was $30 per ton and the freight charge from Pittsburgh to Duluth was $13.20 per ton, the Minnesota Steel Company charged its customers in Duluth $43.20. The steel was made, sold, and delivered in Duluth; and though no freight was paid, the freight charge was included in the price. Steel purchased in Chicago was also billed on a delivered basis at $43.20 when shipped to a Duluth customer. The purchaser in Duluth paid the freight, say $8.00, deducted that amount from his invoice price, and remitted the difference, which was $35.20, to the Chicago mill.

The single basing-point system has been used in steel, corn products, malt, cheese, and a few other commodities. It works satisfactorily only if the production is concentrated at or near the basing point and freight is a relatively small percentage of the cost. Unless these two requirements are met, the price at places far removed is too high. Consumers charge discrimination, and competition is difficult to control.

The multiple basing-point system provides for the use of a number of shipping points as the basis of pricing. As in the case of the single basing-point system, the product is priced on a delivered basis, but two or more basing points are established. Thus, in the steel industry prices are now based upon such production centers as

Pittsburgh, East Saint Louis, Birmingham, South Chicago, and Pueblo. The number of basing points in steel varies from five to ten according to the product, such as hot-rolled sheets, structural shapes, wire rods, and cold-rolled strip. The consumer pays the price at the nearest basing point plus the freight from that point, regardless of the place of manufacture or the manufacturer from whom he buys. Industries operating on a multiple basing-point system include lumber, cement, zinc, copper, fertilizer, gasoline, lead, sugar, and flour.[8]

The excess freight charged is called phantom freight. Under either the single basing-point system or the multiple basing-point system, the freight charged the customer but not paid to a transportation company is phantom freight. For example, a purchaser in Wheeling might buy steel from a mill in Wheeling, call for delivery in his own truck, and thus pay no freight. Nevertheless, he would be charged the price in Pittsburgh plus the freight. The beneficiary is the Wheeling plant which makes an extra profit. Likewise, if a purchaser in New York City buys from a plant in Baltimore, shipment might be by boat; and even though shipment by water is cheaper than shipment by rail, the purchaser would be billed at the Pittsburgh price plus freight by rail from Pittsburgh. The purchaser deducts the actual cost of transportation by water and remits the balance. The extra profit made by the steel mill due to the low cost of water transportation is phantom freight.

In reply to criticisms for making an extra profit through phantom freight, the steel companies contend that the management of the steel mill is entitled to the gain because it used foresight in the location of its mill. They argue also that uniformity of delivered prices rather than uniformity of net prices at the mill is logical because all steel of the same quality and specifications shipped into a market area, such as New York City, should be sold there at the same price regardless of the place of production. To the consumer phantom freight looks like a discrimination.

The basing-point system may be used to eliminate price competition. There are several reasons why a manufacturer may quote prices in accordance with a basing-point system. He may wish to advertise a uniform price to all purchasers, which he may do under this system. He may wish to simplify his price schedules and to

[8] T.N.E.C. Monograph No. 21: *Competition and Monopoly in American Industry*, 1940.

quote only one price. The system may also simplify the figuring of the freight charge, since each purchaser may compute his own delivered price by adding the freight to the base price. The most important reason for the use of the system, however, is that it may eliminate price competition. This conclusion is supported by the fact that the delivered prices are usually the same for all manufacturers, that the seller usually absorbs a part of the freight charge in order that his delivered price may agree with the prices of others, and that prices are frequently maintained for long periods of time without change.

Prices at basing points are determined by price leadership. If a company is a price leader in the territory in which its plant is located but sells in other sections of the country, in those sections removed from its own plant it follows the leadership of some other company. Companies not acting as price leaders follow the leadership of one company in one section and of some other company in some other section. The price leaders are usually the larger companies.

The multiple basing-point system, like other price agreements, is enforced principally by moral sanctions. Usually it is not necessary to attempt any penal measures. When any producer reduces his price on his own initiative, however, others may meet his competition by establishing a basing point in his most profitable territory, which amounts to cutting the price in that section. They may also engage in a general price war. In some cases they purchase the plant of the producer who is causing trouble.

Many industries use a zone-price system. This is a system of pricing whereby delivered prices are uniform throughout certain designated zones regardless of differences in the costs of transportation. For example, in the range-boiler industry the price is uniform for all states east of the Mississippi River. The price is quoted f.o.b. the plant of the manufacturer with full freight allowed. For destinations in other states, the published price is applicable but with only partial freight allowances. All manufacturers use the same system of pricing.

IV. Conclusions as to Gentlemen's Agreements

Gentlemen's agreements are among the oldest forms of combination, for they were common as early as the eighteenth century. They have also been employed continuously since that time and

particularly since 1900. They make a strong appeal to the average businessman whether his business is large or small.

From the business point of view, the gentlemen's agreement is a desirable method of restraining competition. It leaves each producer to manage his own business with a minimum of restraint from outsiders. The agreement is easy to form, since its provisions are very simple. It usually strikes at the most troublesome feature of competition, namely, price cutting. If the plan does not work out to the satisfaction of a member, he is always free to withdraw, and no legal action can be taken against him for breach of contract. Each member is likely to feel that he has nothing to lose by cooperating with the others but that he may gain by doing so. Moreover, basing-point and zone-price systems are legal unless they are imposed or maintained as the result of agreement, combination, or conspiracy that unduly restrains trade or tends to create a monopoly.[9] For these reasons the gentlemen's agreement makes a strong appeal to businessmen, and it usually can be formed with a minimum of appeal and negotiation between the members.

The gentlemen's agreement has serious weaknesses from the business viewpoint. Since a member can withdraw at any time without penalty, the agreement is likely to be of relatively short duration. The lack of centralized organization makes it difficult to deal with non-members and recalcitrant members. Prices are not easy to regulate without an effective control over production policies, plant expansion, and plant construction. The gentlemen's agreement accomplishes none of the economies attributed to large-scale production and is unable to deal with larger problems such as the competition of other industries and the finding of new uses for the product. Most important of all, gentlemen's agreements are illegal if they are formed through collusion or conspiracy. A member who wishes to withdraw can always give as the reason his fear of the antitrust laws, and he is protected by law against any disciplinary action. Despite these weaknesses, however, some gentlemen's agreements have been successful for long periods of time.

From the social point of view, the gentlemen's agreement has little to recommend it. It accomplishes no social savings, and the principal result is to raise prices. Even though an agreement may be temporary and ineffective, it is objectionable if it raises prices even for a short time.

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[9] Staley Manufacturing Co. *v.* Federal Trade Commission, 144 Fed. 2d 22 (1944)

Questions

1. What is a gentlemen's agreement? Are the members always gentlemen, that is, persons of high personal honor?
2. On what three bases may markets be divided?
3. Give an example of an industry in which markets might be divided on each of the three bases.
4. What is price leadership? Is this method more effective than a formal agreement? What are its advantages?
5. Under what conditions is price leadership most effective?
6. Under what conditions is the single basing-point system practical?
7. Under what conditions is the multiple basing-point system practical?
8. How is the net price to be paid the seller determined when a basing-point system of pricing is used?
9. What are the advantages to the vendor of a basing-point system if the system is not used as a form of gentlemen's agreement?
10. What is phantom freight? Is the seller entitled to it?
11. If competition is unrestricted, would you expect a system of delivered prices to operate smoothly?
12. Why should the net proceeds of sale vary for the seller?
13. How does the basing-point system make price agreements easy?
14. What is the zone-price system?
15. Why does the gentlemen's agreement appeal to many businessmen? Why are the agreements usually of short duration?

lem require a permanent organization that establishes a continuous and intimate contact with the members of the pool for the clearance of bids and prices and the investigation of complaints of non-compliance. Members of the pool may be called into conference for the exchange of price information or the discussion of what should be done to control price cutters. The names of buyers and also prices paid may be exchanged between sellers as evidence of the adherence to a fixed scale of prices. Basing-point systems are frequently a part of the price-control plan. Suggested price lists, actually used as a guide in setting prices, may be circulated by a secretary of the pool. Such pools exist at all times in various industries.[1]

A price pool must regulate many provisions of the sales contract in addition to price. These provisions include advertising allowances, brokerage fees paid the buyer or his representative, quantity discounts, arbitrary discounts, cash discounts, advance and season dating, terms of delivery, shipping and insurance charges, guaranties against price decline, options to buy additional quantities at the expiration of the original contract, buying the stock of goods of a customer which he previously purchased from a competitor, trade-in allowances, free deals, samples, premium deals, and entertainment of the customer. Subsequent concessions to a buyer, such as refunds, sales returns, sales allowances, and special prices on allied lines of merchandise must also be controlled.[2] The expenses incurred in enforcing the observance of these provisions are sometimes relatively high.

Price control legislation has been used to bolster a price pool. During the latter part of the decade of the 1930's many of the states enacted legislation prohibiting a wholesaler or retailer from selling below cost. The law, euphoniously called the Unfair Practices Act, was designed to prevent price cutting alleged to be practiced at times by chain stores, but it has on several occasions been used in a manner very different from the original intent. The difficulty arises from the fact that cost is a very elusive term, for as defined in the law it includes a proportionate amount of the rent, sales salaries, heat and light, and other expenses. Consequently,

[1] The annual report of the Federal Trade Commission each year contains a list of complaints entered against price agreements or price pools.

[2] For an illustration of detailed price provisions, see Complaint of Department of Justice under the Sherman Act against Pittsburgh Plate Glass Co. *et al.*, No. 5239, May 23, 1945.

cost has been arbitrarily estimated by a trade group at a figure which represents the resale price to be charged by the members. If anyone sold at less than that amount, he was accused of selling below cost. Members of the trade failing to coöperate were threatened with prosecution under the law.

As an illustration of the misuse of price legislation, the wholesale tobacco and candy dealers in California organized a bureau with a board of directors, a president, and a permanent secretary, and the board held periodic meetings for the comparison of costs, mark-ups, and prices. It made surveys to determine the cost of doing business. The surveys were in fact only an attempt to give legal sanction to arbitrary mark-ups already agreed upon. Price lists and schedules, designated as minimum prices, were issued to the members. Non-coöperating wholesalers were first threatened and then forced to defend themselves in court if they persisted in selling for less than the prices agreed upon.[3]

Sanctions are frequently invoked in price pools. As a pool is not formed unless most of the members favor it, sanctions are necessary only against a few members. The first resort is to educational campaigns, conferences, telegrams, telephone calls, personal visits, persuasion, threats, and cajolery. If these fail, sanctions may be employed.

A mild form of sanction is the purchase of the stocks of the price cutter. This policy may be combined with pressure upon manufacturers or wholesalers to prevent the replenishment of his stocks. Threats of boycott or actual boycott of the sources of supply may be invoked to procure coöperation. Financial penalties may be possible. Fines upon members may be collected under penalty of threat of expulsion from the trade association, or the amount assessed may be deducted from deposits previously required of all members. A price war in the territory of the recalcitrant is also an effective weapon.[4] Newspapers may be persuaded not to publish advertisements of merchandise offered at reduced prices. In some industries such as dairying, the aid of health authorities may be invoked. Labor union officials sometimes coöperate in return for favors. These devices are often quite effective.

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[3] Indictment against Wholesale Tobacco Dealers Bureau of Southern California by Department of Justice, June 26, 1941. Also indictment against Food and Grocery Bureau of Southern California, June 26, 1941. Indictment against Food Distributors Association, Jan. 29, 1941. There have been a number of other similar indictments.

[4] T.N.E.C. Monograph No. 18: *Trade Association Survey,* p. 90, 1941.

Price pools are frequently of short duration. Like the gentlemen's agreement, simple price pools are not usually effective for long periods of time. Since the existence of the agreement must be kept secret, it is difficult for the association to enforce the price scale agreed upon, and impossible to secure the assistance of the courts in enforcing it. The members may suspect each other of reducing prices to obtain business, and whether or not the suspicions are justified, the result is likely to be the dissolution of the pool.

II. Price and Profits Pools

Price and profits pools employ the basic features of the price pool but provide also for a division of profits among the members. The member to whom a contract is awarded pays part or all of the profits into a fund for distribution among the unsuccessful bidders or among the unsuccessful bidders and himself.

The amount of profits to be shared with other members is usually determined through bidding. One plan of operation is for the price charged the customer to be fixed by a board, each member being notified of the price in advance of the bidding. Each member then makes his bid to the pool manager. The bid represents the amount of his profit which the member is willing to pay into the fund for distribution. The contract is awarded to the member making the highest bid to the pool manager. The successful bidder then submits his price to the customer which is the price fixed in advance by the board. Other pool members also submit estimates to the prospective customer, but their estimates are sufficiently high to assure that they will not be awarded the contract.[5]

A second plan of the price and profits pool is for the amount to be paid to unsuccessful bidders to be fixed by the pool manager. The members are notified of the amount, which they include as a part of their costs before submitting bids to the prospective customer. The amount added by the pool manager may be merely sufficient to compensate the others for their costs in making bids or it may be a larger amount.[6]

A third plan of operation is to compute the profits made by the successful member on each contract awarded. The difficulties of

[5] This was the plan followed by the famous Addyston pipe pool. Addyston Pipe and Steel Co. *v.* United States, 175 U.S. 211 (1899).

[6] This was the method employed by the Associated General Contractors of America, New Orleans Chapter. Complaint of the Department of Justice, No. 249, filed Jan. 15, 1940.

carrying out a plan of this kind are very great because of the accounting problems in the computation of profits, especially the allocation of overhead expense including depreciation of property and equipment. Materials and labor costs involve less difficulty but nevertheless present many problems. It also becomes necessary to audit the cost figures of the member awarded the contract. Because of the accounting difficulties and the necessity for secrecy, this type of pool is too complicated for use by industrial corporations. It has been used to a limited extent among the railways. Under this plan, one railroad company may operate a passenger train between two large cities served by two or more roads, and the other roads discontinue service at the same hour of the day, thus saving a part of the costs of operation. The road which is awarded the privilege of operating the train shares the profits with the others. The Transportation Act of 1920 gave the Interstate Commerce Commission the authority to approve pooling if it appeared to be in the public interest to do so. While there has been some pooling under the Act, the railroads have not appeared to be anxious to take advantage of the provision. Perhaps the reason is that government regulation has removed most of the worst evils of competition. Another reason is the necessity for serving way-stations as well as the terminal cities.

III. Agreements to Curtail Production

When a pool is formed for the purpose of curtailing production, it is usually a part of a larger agreement such as a price pool or a price and profits pool. (Since an increase in the price of the product may result in a decrease in sales, some provision may be made to keep surplus products off the market.) Such an agreement may provide for the disposal of existing stocks as well as a decrease in the current rate of production.

Output may be curtailed by limiting the season or period of production. The production of a highly perishable product such as oysters has at times been reduced by limiting the season for processing or canning. Similarly, the production of sponges in some years has been curtailed by closing for a time the exchange through which sponges are marketed.[7] (Members of an industry may also agree not to carry out new construction projects for plant expansion or not to open additional plants which were closed at the time the

[7] T.N.E.C. Monograph No. 18: *Trade Association Survey,* p. 85, 1941.

agreement was made. Manufacturers may also agree to limit the number of days each week their factories will operate or the number of shifts or hours per day. Shipping companies have accomplished the same result by agreeing to limit the number of sailings per month.

Output may be decreased by limiting the quantities to be produced. The pool members may agree to curtail production through a control of quantities and also types of product. This is easily accomplished if the members own patents which must be used in the manufacture of the product. For example, the owners of patents covering machines for the manufacture of glass bottles and jars, after pooling their patents, licensed various manufacturers to produce annually a limited number of milk bottles, cheese jars, beverage jars, or other glass containers. In this manner they limited the total production to protect themselves and also their licensees.[8]

A pool limiting output was formed by the large oil refining companies in 1935. The companies agreed to purchase increased quantities of oil from the producers of crude oil at prices higher than those prevailing at the time of purchase, in return for an agreement from the producers of crude oil to reduce output. The effect of the agreement was to curtail production and at the same time to remove from the market large supplies of oil. The costs of the program were shifted to jobbers in the higher prices for gasoline and oil, and the jobbers in turn increased their prices, thus shifting the cost to consumers. In 1940, the United States Supreme Court held the pool to constitute a violation of the antitrust laws.[9] Later in the same year another suit was filed against the same companies and their trade association charging limitation of output, price fixing, and price leadership.[10]

IV. Pools Providing for the Allotment of the Business

The pool which provides for the allotment of business among the members is usually supplementary to other pooling agreements. Many pools have come to an early end because of jealousy and suspicion between the members, each member fearing that he is not

[8] Complaint filed by Department of Justice against Hartford-Empire Co. *et al.*, Dec. 11, 1939. For a similar arrangement in the plate glass and flat glass industries, see complaint against Libbey-Owens-Ford Glass Co. *et al.*, May 23, 1945.

[9] United States *v.* Socony-Vacuum Oil Co., 310 U.S. 150 (1940).

[10] District of Columbia District Court, Civil action 8524.

getting his share of orders. A scramble for business is most likely to occur when markets are depressed or when effective demand has been decreased through a rigging of the price. The provision for allotting business is designed to assure each producer that he is getting his share. To assure that the plan is being carried out, continuous reports and checks on production are required.

Pooling agreements allotting quotas require detailed enforcement provisions. The provisions and methods employed are illustrated by the procedure which has been developed by some trade associations. The steps required are as follows:

1. The fixing of quotas comprising percentages of the total production for the industry and the assigning of the quotas to the members. Quotas may be based upon production capacities or sales during the preceding year or other period.

2. The acceptance of the quotas by the members and an agreement to adhere to them. The plan usually masquerades under some high-sounding slogan, such as "Live and let live," "Prorationing of the business," or "Equitable sharing of available business."

3. Transmission of weekly or monthly forecasts of estimated demand for the product by the secretary to the members for use by them in regulating their production.

4. Reports from the members to the secretary covering production, inventory, bids, shipments, unfilled orders, and prices charged. The reports may include copies of orders from customers, sales invoices, and other documents showing production and deliveries.

5. Reports by the secretary to the members showing production for the industry and giving the names of members who have exceeded or failed to produce their quotas.

6. Regular and secret meetings of the members or groups of members to hear reports, discuss the administration of the plan, and maintain the solidarity of the membership.

7. Communications to members urging them to produce no more than their quotas.

8. Periodic audits and examinations of books and records to verify reports of members.[11]

Production quota plans have sometimes been enforced through the offices of the trade association. The association affords a con-

[11] Adapted from indictment of Kraft Paper Association *et al.* by Department of Justice, July 20, 1939; also indictment of Hartford-Empire Co. *et al.*, Dec. 11, 1939.

venient means for such a scheme: first, because the membership frequently includes a large percentage of the industry; second, because the trade information collected by many trade associations affords a statistical basis for the assignment of quotas; and third, because the spirit of comradeship fostered by trade associations easily leads to a desire to eliminate competition. A management company is sometimes employed to assist in fixing quotas and administering the plan.[12] Since the management company is not a member of the industry, it may be able to allay suspicions between the members and to act as arbitrator of disputes.

Various methods are employed to require adherence to the plan. Trade associations rely principally upon threats and cajolery, though fines are sometimes levied for excess production. Threats of expulsion may be effective, but expulsion is unsatisfactory because members outside the association are free to produce and sell any amount they please. If the use of a patent is required in production, a threat of patent suit may be resorted to.[13] Even though fines are assessed, members may find it desirable to exceed their quotas to provide an argument for a larger quota the following year. Members not producing their quotas may find their allotments decreased in the next year.[14]

V. Pools Dividing Markets

Pools dividing markets, like gentlemen's agreements for dividing markets, are of three types: (1) division of markets by customers, (2) division of markets by products, and (3) division of markets by territories. The market pool differs from the gentlemen's agreement in that the arrangement is more definite, is expressed and not implied, and is enforced by some sort of sanction. (The pool for the division of markets is frequently a part of a larger agreement such as the fixing of prices, the limitation of production, or the removal of surplus supplies from the market.) Supplementary provisions may be considered necessary because some areas may be left open for sales by all members of the industry. Moreover, transshipment from one area to another may be possible if considerable

[12] See, for example, indictment of National Container Association, Aug. 9, 1939.

[13] See description of quota arrangements in elevator industry, T.N.E.C. Monograph No. 21: *Competition and Monopoly in American Industry,* p. 252, 1940.

[14] For discussion of operation of quota pool among packing companies, see indictment of American Meat Institute, June 19, 1941.

differences in price are permitted, or if excessive quantities are sold in one area by the member to which the area is assigned.

Division of markets by customers has been a common method of sharing business. When markets are divided by customers, the purchasers are usually required to do business with one vendor. They merely continue to buy from the sources previously available to them, and other vendors refuse to accept orders from them. Another effective method is for one vendor to quote high prices to customers of another. Labor unions have sometimes assisted in enforcement by refusing to make deliveries or otherwise to serve purchasers not confining themselves to their assigned sources of supply.

In some cases, the orders of purchasers are apportioned among manufacturers without the knowledge or consent of customers.[15] The buyers for meat packers have at times used the method of a toss of a coin to determine which buyer would take the next carload of sheep, cattle, or hogs.[16] The division of markets by customers has been followed in the poultry, textile refinishing, and fertilizer industries.[17]

Allocation of markets by products may be based upon patents. A company which owns patents used in the manufacture of several products may permit licensees to produce only one or two of them. For example, the Hartford-Empire Company, after combining with the Owens-Illinois Glass Company to acquire control over various patents for making glass containers, licensed one company to manufacture fruit jars, another water bottles, another beer bottles, another milk bottles, another jugs, and another bottles of a certain size of amber glass. When two or more companies were granted licenses to make the same kind of container, quotas were assigned to each and the quota plan was enforced by statistical reports and periodic audits similar to those described in the discussion of pools allotting production. Prices were controlled by contract and by the policy of price leadership in the respective branches of the industry.[18]

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[15] This method was used by manufacturers of snow fence. Federal Trade Commission, Docket 3305, Jan. 18, 1938.

[16] Indictment of American Meat Institute, June 19, 1941.

[17] Greater New York Live Poultry Chamber of Commerce *v.* United States, 34 Fed. (2d) 967 (1930); United States *v.* Textile Refinishers Association, Stipulation decree, May, 1936; T.N.E.C. Monograph No. 18: *Trade Association Survey,* p. 86, 1941.

[18] United States *v.* Hartford-Empire Co. *et al.,* complaint filed Dec. 11, 1939.

VI. Pools Providing for a Joint Sales Agency

An effective means of controlling sales policies and prices in an industry is for all members to sell through the same sales agent. A corporation is organized for the express purpose of negotiating with purchasers. The corporation sells its stock to the members of the industry for which it is to act as sales agent. The amount of stock sold to a manufacturer usually depends upon his productive capacity. The sales agent allocates orders received and arranges contracts for a commission. After paying its expenses, the corporation pays any earnings to the members of the industry as dividends on its stock. In this way, production is controlled, quota prices are effectively carried out, and prices are fixed.

Joint sales agencies are operating in the bituminous coal industry. The first joint sales agency in the coal industry was Appalachian Coals, Inc., which was organized in 1932 by mining companies in parts of Kentucky, Tennessee, Virginia, and West Virginia. The company contracted to act as exclusive sales agent and was given complete control over the quantity of coal to be sold and the prices, terms, and conditions of sale. It agreed to apportion the available orders among the members on a quota basis, arrange the sale, collect from the purchaser, and remit the proceeds to the mining company after deducting a commission of ten per cent. The authorized capital stock of the corporation was 1,000 shares of common stock of $100 par value and 9,000 shares of seven per cent preferred stock of $100 par value. Common stock was given exclusive voting rights. Both common and preferred stock were sold only to members of the pool.

When Appalachian Coals, Inc., was organized, there was doubt as to its legality under the antitrust laws. The company sold one carload of coal to test the legality, and in 1933 the Supreme Court decided that the plan was legal. The court held that although the sales plan partially restrained trade, there was still competition with mining companies in other parts of the country. A further justification was that the plan represented an attempt to eliminate unemployment and intermittent employment, to provide for a better utilization of natural resources, and to correct other evils. The court [19] said:

"When industry is grievously hurt, when producing concerns fail, when

[19] Appalachian Coals, Inc. *v.* United States, 288 U.S. 344 (1933).

unemployment mounts and communities dependent upon profitable production are prostrated, the wells of commerce go dry. . . . The fact that the correction of abuses may tend to stabilize business, or to produce fairer price levels, does not mean that the abuses should go uncorrected or that coöperative endeavor to correct them necessarily constitutes an unreasonable restraint of trade."

After the 1933 decision, similar selling agencies were organized in other parts of the country. The sales agencies in the industry were legalized by the code under the National Industrial Recovery Act. After that law was declared unconstitutional in 1935, provision was made for the continuance of the sales agencies in coal in the National Bituminous Coal Act.

Joint sales agencies have been employed by few industrial pools. The difficulty with the use of a joint sales agency plan is that it is usually illegal and the plan must therefore be kept secret. Secrecy is difficult because of the necessity for procuring a corporate charter. The best known sales agent in industry was the Michigan Salt Association which successfully operated as agent for salt-producing companies in Michigan from 1876 to 1900. The legality of this pool was never tested in court, but the pool dissolved after failure to carry through an ambitious plan to include the New York state salt wells. More recently the plan was tried by the manufacturers of wood sticks used for ice cream and candy bars. The sales agent and members of the pool were sued and the corporation was dissolved in 1939.[20]

VII. Patent Pools

A patent pool is an exchange of patent rights between two or more owners of patents. An exchange of patent rights may make it possible for a manufacturer to use a great many patents in return for the use of a limited number which he owns. In the manufacture of certain machines or other complicated devices, several patents may be necessary to make the complete product. The patent pool may also avoid controversies between owners of patents over what appear to be overlapping or conflicting grants.

The pooling of patents may be accomplished in a number of ways. The following methods of exchanging patent rights are most common:

Consent decree, D.C., S.D., N.Y., June 6, 1939.

1. The holders may retain title to them but exchange reciprocal licenses to use them.

2. Owners of patents may transfer title to a trustee who is authorized to distribute licenses to all members of the pool upon terms previously agreed upon.

3. Owners may sell their patents to a corporation in exchange for its stock.

4. Owners may grant powers of attorney to a common agency which is authorized to distribute licenses.

Patents have been pooled in the radio industry through the Radio Corporation of America. The formation of a patent pool in the radio industry began in 1919 when the Radio Corporation of America was organized by the General Electric Company to take over certain patents. Shortly thereafter, the Radio Corporation acquired the patent rights and other assets of the Marconi Telegraph Company of America, which had already been formed for the purpose of communicating with ships at sea. The Radio Corporation later made a series of cross-licensing agreements with a number of other companies owning radio patents, including the American Telephone and Telegraph Company, the Western Electric Company, and the Westinghouse Electric and Manufacturing Company. The companies agreed to coöperate with each other in the development of new inventions relating to radio and to exchange the right to use patents covering their research in that field, and as a result of this agreement 4,000 or more patents were pooled.

Many of the patents covered similar features of radio manufacture, but some were complementary. Several of them would be necessary to the manufacture of a single radio set. Hence the Radio Corporation was given the exclusive right to license the use of the patents, and it issued licenses to various manufacturers permitting them to use the patents on a royalty basis. The licensees complained that the charges were excessive because competition had been eliminated between the holders of the patents which had been pooled. Moreover, the Radio Corporation had also entered into contracts for the exchange of patent rights with companies in Great Britain, France, and Germany, and the contracts with corporations in these and other foreign countries included many features that the government contended had the effect of restraining trade. In November, 1932, the Radio Corporation, the General Electric Company, and the Westinghouse Electric and Manufac-

turing Company consented to modify their agreement in certain respects, the most important of which was that they would not grant exclusive licenses to each other. The agreements of the General Electric Company and the Westinghouse Company whereby those companies had restricted their own rights to manufacture radio equipment were declared void. General Electric and Westinghouse were required to dispose of the shares of Radio Corporation stock owned by them and to have no interlocking directorates with the Radio Corporation.

In the oil industry patents for cracking crude oil have been pooled through mutual licensing agreements. The patent pool in the oil industry goes back to 1912 when the Standard Oil Company of Indiana perfected an improved method of manufacturing gasoline which came to be known as the cracking process. The cracking process, by which gasoline is produced by subjecting the crude oil to high temperatures and high pressure, made possible the production of a greater quantity of gasoline from the crude oil than was possible by the old skimming process. In 1914 the Standard Oil Company of Indiana issued licenses to a number of other companies to use the process, but prohibited them from selling cracked gasoline in certain states, which came to be known as Indiana Territory. Not long afterward, the Texas Company perfected a similar process that seemed to be even better than the method developed by Standard of Indiana, and because of the similarity of the two processes the Texas Company alleged that not only the Standard of Indiana but also all of the companies with which it had made licensing agreements were infringing its patents. The difficulty was settled in 1921, when the two companies entered into a cross-licensing agreement which permitted each company to use the patents of the other and provided for the sharing between them of all royalties received from the licensing of the patents to others.

Another company, the Gasoline Products Company, now perfected a similar patent, and it began to issue licenses. It was cutting into the business of the other two companies, and in 1923 the Texas and Indiana companies admitted it as the third member of the licensing agreement. The Standard Oil Company of New Jersey had perfected a patented process for cracking gasoline in 1921, and in 1923 it also joined the cross-licensing combination.

The government alleged that the agreement constituted a combination in restraint of trade—that the patentees had combined to eliminate competition in licensing others to use the patents, and

that the contracts permitted the oil companies to maintain royalties which were an important element in the cost of gasoline. The companies replied that the pooling of patents offered them the only means of avoiding endless patent litigation which would involve not only themselves but also the licensees; and they argued further that the patent law gave them the right to use the patents as they pleased and that there had been no use of the patents for purposes of restraining competition. In April, 1931, the pooling arrangement was held to be legal in a decision of the Supreme Court.[21] It was said that an agreement for the pooling of competing patents or an agreement for cross-licensing and division of royalties violates the antitrust act only when used to effect a monopoly or to fix prices, or to impose an otherwise unreasonable restraint upon interstate commerce.

Some patent pools are legal while others are illegal. The patent pool has presented a difficult problem because of the fact that the patent law and the antitrust laws are contradictory in purpose. The patent law is designed to confer a monopoly of manufacture while the antitrust laws are designed to prevent or dissolve a monopoly. In practice, however, the patent pool may constitute a voluntary dissolution of a government-protected monopoly since the holder of a patent agrees to permit others to use it. On the other hand, the patent pool may be a device to eliminate competition between the holders in licensing others and may therefore be illegal. The question which must be resolved in each case is how far the holder of a patent may legally go in combining with others for the use of each other's patents.

During the Second World War, there was a general exchange of patent rights in many industries in the interest of national defense. One reason for the rapid arming of the country was the general exchange of patent rights. Manufacturers even supplied other companies with technicians to supervise the installation and operation of machines for production.

VIII. Webb Export Associations

(Webb export associations are combinations or pools, the members of which are engaged in the export trade of the United States.) They are called Webb associations because their operations were made

[21] Standard Oil Company (Indiana) *v.* U.S., 283 U.S. 163, 51 Sup. Ct. 421 (1931).

legal by the Webb-Pomerene Act (or simply the Webb Act) of 1918. Their method of operation in foreign trade is similar to the ordinary price and market pool or, in some cases, to the pool with a joint sales agency, in the domestic market.

The Webb Act granted exemption from the antitrust laws to combinations in the export trade. The Act states that an association entered into for the sole purpose of engaging in export trade is exempt from the provisions of the Sherman Antitrust Act of 1890 and the Clayton Act of 1914, provided the association does not enter into any agreement that results in a restraint of trade within the United States. If any association enters into any agreement that artificially enhances or depresses prices within the United States, it loses the protection of the Act. An association is not permitted to take any action which restrains the trade of domestic competitors.

At first it was believed that an association, to be considered an export association, had to serve as a sales agency and sell the goods. The Federal Trade Commission decided in 1924 that the association might merely fix the prices at which members would sell. The Commission also stated that an export association might combine with a foreign cartel for fixing prices and apportioning production in foreign markets, provided the agreement did not extend to the domestic market. This decision has had far-reaching effects upon the organization of the export trade.

The enforcement of the Act is entrusted to the Federal Trade Commission. Every association wishing to avail itself of the law is required to file a report with the Commission covering its purposes, practices, and organization. It must also file an annual report describing its activities for the year. If the Commission suspects that an association is restraining trade within the United States, it is authorized to investigate, but its power is limited to ordering the association to correct the objectionable practice. If an association refuses to obey an order, the matter may be referred to the Attorney General for action. The enforcement provisions of the Act are not strong.

The purpose of the Act was to place American exporters on an equal competitive basis with foreign exporters. In advocacy of the law it was urged that foreign producers and distributors were organized for both domestic and foreign trade. Large European producers were members of international agreements for fixing prices, establishing quota systems, apportioning and controlling production, dividing markets, interchanging patent and process

rights, and controlling industry and trade in other ways. When American manufacturers entered the foreign markets, they were required to meet the competition of these large organizations. A further argument was that the foreign buyers were able to force down American export prices by playing one producer against another.

There was a great deal of opposition to the proposed law. It was argued, first, that it was morally wrong to permit a combination in the foreign trade which was prohibited in the domestic trade. If the legislatures and the courts thought it was proper to protect the domestic consumer against monopoly prices, the same protection should be extended to the foreign consumer. It was argued, second, that it was impossible to distinguish the foreign market from the domestic market, and if a combination controlled the prices of goods in the export trade, its influence would inevitably be extended to the domestic trade. Whether these fears were justified is still undetermined.

Many of the export associations are merely price-fixing combines. Since 1924 few selling agencies have been organized, and most of the export associations merely fix prices and sales quotas. Orders received by the association either directly or through foreign agents are allotted to members upon an agreed percentage. Shipment is made by the members, and payment is made direct to them by the buyers. Associations of this kind are usually not incorporated.

Associations acting as exclusive sales agents perform many services for the members in connection with the shipment. They ship the merchandise, collect for it, and remit the proceeds to the members for whom it was sold. In some cases the association deducts a certain percentage from the proceeds of each sale to cover its expenses, and in other cases the members are assessed for the expenses in the proportion in which they participate in the sales. Associations of this type, also, are usually incorporated.

The associations frequently perform many functions of incidental nature. They frequently adopt forms for contracts, including the terms of sale. Some of them establish rules and regulations for the packing and shipping of the goods for export. Insurance papers and shipping documents may be arranged for the members. If the products of all members are uniform in quality, as in lumber, the association may adopt a joint trade-mark for the industry and promote sales by joint advertising. In cases of dispute with foreign

buyers it may employ a claim agent and arrange for the settlement of the dispute. If arbitration proceedings are necessary, the association may represent the American exporter. In a few instances the association collects and disseminates trade information among the members, the information relating to such matters as stocks available for export, market conditions abroad, the credit standing of foreign buyers, foreign-exchange problems, and tariff and other laws affecting the export trade.

The associations assumed new functions during the war. When severe export restrictions were instituted by the government during the Second World War, the associations assisted the members by handling their export problems. Under the plan evolved by the government, an association made application for shipping space and was awarded a stated amount which it divided among the members. This procedure resulted in an equitable distribution of shipping space and a reduction of paper work. It also enabled each shipper to receive advance notice of how much he would be allowed to ship. Associations were especially active in such industries as plate glass, fertilizers, textiles, lumber, fresh and dried fruit, walnuts, rice, flour, and milk.

The associations have many advantages for exporters. The enumeration of the services performed by the associations indicates the advantages which accrue to the members. Many small exporters would be unable to maintain a sales agent abroad, and the unfamiliarity of many manufacturers with the technicalities of foreign exchange and other problems arising in the export trade has been a handicap to them in developing their trade abroad. The spreading of the overhead of the shipping service and of the maintenance of foreign sales offices over the entire industry has, no doubt, lightened the burden and encouraged the development of the export business.

Many of the associations have encountered difficulties. A number of the associations have been disbanded. The reasons have been personal dissensions, lack of business, and the preference of the members for doing business through their own organization or a commission house. Manufacturers of consumers' goods and trademarked goods have hesitated to organize export associations for fear that the goodwill associated with their product might be lost. They wish to maintain their own sales agencies or branches abroad in order that they may advertise and push the sales of their individual products.

IX. Evaluation of Pooling Agreements

In the discussion of patent pools and Webb export associations, the business and social advantages of those types of pools have been commented upon. In the remainder of this chapter, therefore, the discussion will be confined to other types of pools.

The pool appeals to many businesses as a desirable form of combination. The principal advantage of the pool from the business point of view is that it eliminates competition while permitting each business to retain control of its own affairs. The individual usually prefers to manage his business himself rather than to become a part of a big corporation, but he also likes to avoid some features of competition. The pool permits him to do both.

A second advantage is that the pool may be adapted to the desires of the parties concerned. A pooling agreement may provide any method of dividing profits or sharing markets or allotting production quotas. The degree of control granted to the pool managers may be great or small as the situation seems to require.

A third advantage is the ease of formation. Prior to the enactment of legislation making pooling agreements illegal, businesses were willing to enter pools because there was usually much to be gained and not much possibility of loss. Each business retained control of its own affairs, and what profits it made were its own. If matters did not go as planned, a business could always withdraw; although to be sure, if security were deposited with the pool manager as evidence of good faith, this might be lost, since a suit for a return of the security could not be sustained at law. The formation of the pool, like the formation of a partnership, involved no legal formalities, and there were no organization taxes to pay.

The pool has serious disadvantages from the business point of view. The principal disadvantage of the pool is that it is illegal. By the common law the agreements were void and unenforceable, and the elimination of competition was likely to be only temporary. When any manufacturer decided to withdraw from the pool, he could do so without fear of a suit for breach of contract. In fact, it was said that the pooling agreements of the steel producers during the decade of the nineties were broken with such regularity that buyers were accustomed to postpone purchases until the pools were dissolved. When pooling which restrained trade was made an offense under the state and Federal antitrust acts, the formation of a pool carried a real hazard to the participants.

A second disadvantage of the pool is that it is not able to keep out competition. If the pool is successful in raising prices, competition is likely to appear, and when an independent producer begins to undersell the pool, the members are likely to withdraw. The pool succeeds best if the number of competing manufacturers is small and if a large amount of capital is required to enter the business. Competitive businesses cannot be easily established and the small number of concerns is more easily held together than a larger number would be.

A third disadvantage is the necessity for secrecy. The necessity for dealing underhandedly with the public frequently leads to dishonesty among the members, and a bad code of business ethics is injurious to the members as well as to the public. It is easy for members to take unfair advantage of each other when nothing can be made public. The suspicion of unfairness is a frequent cause of the dissolution.

A fourth disadvantage is that a far-sighted business policy is impossible for most pools. In most cases the primary concern of the members is to increase profits by increasing prices. When the pools determine prices by a vote of the members, the usual result is an increase, and this is often unwise from the business point of view because the higher prices attract competition and the competition causes the break-up of the pool.

From the social point of view, the pool has little to recommend it. The pool eliminates some of the wastes of competition while offering to each manufacturer an inducement to manage his business efficiently. On the other hand, it is bad for the consuming public to be subjected to monopoly prices, and even if the pools are of short duration, the consumer may be subject to a series of monopolies. If large-scale production would secure economies, the pool fails to accomplish them, since it is primarily a device for securing a reduction of output and an increase in prices. The secrecy surrounding the pooling agreement creates a business attitude that is bad for both business and the public.

Questions

1. How does a pool differ from a gentlemen's agreement?

2. What is the difference between the simplex pool and the duplex pool? Which is more common?

3. What features of the sales agreement must be regulated in addition to price in order to make a price pool effective?

4. How can a price pool control competition from persons not in the pool and competition of other industries? Give examples of competition between industries.

5. How has price control legislation been used to make price pools effective?

6. What are the three ways of dividing profits in a price and profits pool? Which is simplest to operate? Which is most complicated?

7. What methods of curtailing production have been used in pools designed to limit production?

8. What procedure is followed in making effective pooling agreements allotting quotas?

9. How are markets divided in pooling agreements?

10. How can members of a pool enforce an agreement which assigns each customer to one seller?

11. Is a pool which provides for a joint sales agency an effective method? Why is it not more generally used?

12. What methods of exchanging patent rights are used?

13. What has been the difficulty of the courts in enforcing the anti-trust acts against patent pools? Since a patent is a monopoly, can the holder use the patent in any manner he chooses without being accused of fostering monopoly?

14. For what reasons do holders of patents pool their rights?

15. Is the patent pool socially desirable?

16. What was the reason for legalizing pooling agreements in the export trade?

17. What were the objections to the legalizing of pools in the export trade?

CHAPTER XX

National and International Cartels

A cartel, or kartel, is the European counterpart of the American pool. It is a form of combination among manufacturing firms by which independent businesses in an industry agree to regulate their output, to fix quotas, and to control sales contracts and prices.[1] A combination of retailers or wholesalers for the sole purpose of regulating prices would not usually be regarded as a cartel.

Cartels have had their greatest development in Germany where they have been encouraged and regulated by the government. They began as loose combinations of domestic producers, but in time their ramifications overran national boundaries to include competitors in France, Belgium, the Netherlands, Switzerland, and eventually, the United States. In a few cases American or British corporations took the initiative in forming international agreements. Some such combinations include no German manufacturers because there are none in the field.

I. Cartels in Germany

Cartels have had a greater development in Germany than in neighboring countries because of economic and geographical differences. Territorially, Germany is a relatively small, compact, densely populated country, inhabited by a thrifty industrious people. Prior to the First World War, it had a few colonies in Africa and some islands in the Pacific, but these were lost by the Treaty of Versailles. Consequently German industrial development has proceeded out of proportion to the domestic markets; but because of tariffs and preferences set up in other countries, foreign and colonial markets have at times been unwilling or unable to absorb the surplus production which Germany wished to dispose of. Since the

[1] Originally the word cartel meant a written agreement or convention between opposing nations in view of or during war for the regulation of intercourse between them. Cartels between nations provide for postal and other communication, for the mode of reception of bearers of flags of truce, for the treatment of the wounded and prisoners of war, and similar problems.

domestic market in Germany was reserved in part to German industry either through restrictions set up by the government or through protection of transportation costs, cartels were organized to allocate the limited volume of sales orders to domestic producers. The alleged purpose was to eliminate some of the undesirable effects of competition and to assure a fair return to manufacturers wherever possible.

The German Government has traditionally encouraged cartels because it was interested in preventing wide-scale bankruptcies in time of depression and in maintaining employment and also because it wished to build up a strong industrial country. The military needs have long been an important consideration. Wedged in between the great powers of France and Russia which it both feared and envied, Germany has long made preparedness for war a primary consideration. The cartel movement, in strengthening German industry, aided in the development of military power.

Cartels began in Germany about 1875. There were several reasons for the beginning of the cartel movement about 1875. Germany had gone through a period of great industrial expansion after the Franco-Prussian War of 1870. The ensuing crisis in 1872 found German industrial capacity greatly expanded, particularly in the heavy industries of coal, iron, and machine production. Capital could not be withdrawn from these industries or diverted to other uses, and manufacturers were tempted to cut their prices to obtain a share of the limited volume of business in order to meet their fixed charges. Cartels were therefore organized in such industries as coal, coke, pig iron, steel, potash, cement, and glass in order that each firm might be assured its quota of business without price cutting.[2] These industries have continued to be under the control of cartels during most of the time since the seventies. The cartel movement has also extended to many other industries including lime, textiles, chemicals, dyestuffs, and photographic materials. It has also spread to later processes of manufacture, such as steel girders, cables, tin plate, rails, wire, and semi-finished iron.

The German Government early began to regulate and to encourage cartels. The government found it expedient to intervene in the organization of cartels long before the First World War. The

[2] Karl Pribram: *Cartel Problems,* Brookings Institution, Washington, 1935. Also Robert Liefman: *Cartels, Combines and Trusts,* Europa Publishing Co., Ltd.. London, 1927. Rudolf Michels: *Cartels, Combines and Trusts in Post-War Germany* Columbia University Press, New York, 1928.

cartel system easily lent itself to abuse; and although the large and well-known cartels did not use their power to raise prices to exorbitant levels, many of them failed to show proper consideration for the welfare of consumers. Some cartels, including those in the textile industries, were compelled to lower prices. In 1910, the government required that a large cartel in the potash industry be reconstituted in order to prevent its collapse, and later the Rhenish-Westphalian coal cartel was reorganized under threat of government intervention. The reason for the concern of the government in the stability of these cartels was a desire to maintain a regular supply of their products for domestic consumers and for export. Later cartels were organized in other industries at the suggestion of the government. Industrialists did not oppose government interference because each was assured a quota of the available raw materials and sales orders at satisfactory prices.

Cartels rendered great service to the German Government during the First World War. During the war the government made use of the cartels for supplying the requirements of the various branches of the armed forces. The cartels were of more assistance to the government than were trade associations in the United States because they were much better organized. At the suggestion of the government, new cartels were formed in other industries, especially in those industries which received large orders for war supplies. Cartel machinery was used to control and allot raw materials and assign production quotas. Prices were effectively controlled because the cartels could fix the prices of their products. They also aided in regulating manpower and wage levels. Some price and wage increases were permitted to stimulate production and to eliminate discrepancies, but the stability of the economic system was generally maintained.

Cartels declined in importance for a time after the First World War. During the period of inflation following the war, prices advanced so rapidly that the fixing of prices in individual industries became unimportant. Sellers could get almost any price they asked because purchasers were anxious to buy before further price increases occurred. The members of cartels were primarily interested in buying up as much plant and equipment as they could in order to avoid the effects of depreciating currency and to profit from soaring commodity prices. Huge corporations were built up through the acquisition of the properties of their competitors. Cartels decayed rapidly as many small concerns disappeared. Cartel agreements

were replaced by industrial agreements which attempted to control the terms of sale in an effort to shift to purchasers some of the risks attendant upon a depreciating paper money. However, the concern of the government with the problems of the control of industry greatly increased as a result of the difficulties of that turbulent period.

A cartel court was established in Germany in 1923. In November, 1923, the German Government issued "an order against the misuse of monopoly power." It established a court with power to consider controversies concerning cartel agreements. It was decreed that all contracts which had for their purpose the control of production, marketing, prices, or other conditions of business must be in writing. The court was empowered to declare any contract invalid if it found that they endangered the welfare of the community by restricting production or marketing in an uneconomical manner, by unduly increasing prices, or by inequitably restricting the freedom of the members. The powers of the cartel court were thereafter effectively used against many exclusive contracts and the dissolution of some cartels was required. In the main, however, the cartel court used its powers to permit a member of a cartel to withdraw and thus to terminate his contract without advance notice. This procedure was permitted if an agreement was found not to be in the common welfare. The court was superseded by other agencies after Germany adopted National Socialism.

The cartel increased in importance after the period of monetary inflation had passed. Realizing that many of the huge combines in Germany had been built up as a result of the "flight from the mark," the government required many of them to surrender control of the plants which they had acquired. After the mark was stabilized in 1924, the dissolution of many large combines was speeded by the scarcity of liquid capital. The newly created industrial units in many industries drew together to form cartels. In a few industries the experience during that period seems to have been just the opposite. The shortage of capital and the necessity for a reduction in operating costs required the fusion or amalgamation into a single corporation of many of the firms which formerly competed with each other. Large combinations were formed in steel and other industries, but the best known is the great chemical company of I. G. Farben[3] which was organized in 1925. This huge combine

[3] The full name of the company is Interessengemeinschaft Farbenindustrie Aktiengesellschaft.

produces pharmaceuticals, fertilizers, explosives, film and photographic supplies, rayon, aluminum, magnesium, synthetic gasoline, synthetic rubber, and other such products. It conducted much of the German research for war and was also used to prevent or hinder defensive preparations in the United States.

Germany used cartels effectively before and during the Second World War. When Hitler came to power in Germany in 1933, the National Socialists found the cartel a valuable instrument for accomplishing many of their purposes. Within Germany, it was used to control prices, to assure a percentage of the production to favored companies, to increase production through assignment of quotas, and to control the flow of capital to those industries which the government wished to develop. In the international field, the cartel was used to build up productive capacity in certain industries and to retard development in other countries, to encourage research in Germany, to acquire foreign exchange for the purchase of a stock pile of strategic materials, and to accomplish other purposes. After the war began, the cartel served other similar purposes.

The activities of the cartel are varied. The types of activity conducted by cartels are similar to those which are carried on by pools in the United States. The most limited type of activity is the fixing of the terms of sale, such as methods of delivery, packing, shipping, and insurance; terms of credit, discounts, and methods of payment; and subsequent concessions to purchasers, such as returns and allowances. The organization may go a step further and fix prices in a manner similar to the price pool. Cartels commonly limit production in an effort to produce no more than the market will absorb at the price agreed upon. The limitation of production necessitates an allotment of quotas in order that each member may be assured his share of the limited business, and the allotment of quotas is most effectively enforced through the establishment of a joint sales agency. The cartel may also provide for a division of the market along territorial lines with certain designated companies assigned to each area. Within the territories assigned, quotas are established fixing the amount to be produced by each firm. If a purchaser asks that bids be submitted, the member firms secretly agree upon the distribution of the contracts and then make fictitious bids in a manner similar to that followed by certain types of pools.

The cartel has had limited development outside of Germany. Cartels have not been developed on an extensive scale in England largely because that country has followed a policy of free trade

throughout much of its recent history. As a result, a monopoly of the home market was not easily established, though there have been monopolies in a few industries. The British have been interested in keeping prices low in order to gain access to markets in other countries. Possibly the existence of colonies and overseas dominions with extensive markets has been another factor. Many British corporations have participated in international cartels for the control of raw materials.

In many other countries of Europe, there has been a limited development of cartels, particularly since the close of the First World War. A national cartel is not likely to be successful in a small country such as Czechoslovakia, Switzerland, Austria, or Hungary because markets are limited. However, the development of cartels in those countries and also in France and Italy was great enough prior to 1939 that they were considered national problems in all of the countries of western Europe.

II. International Cartel Agreements

The formation of an international cartel presupposes a control of the national market by one or a few companies or by a national cartel. The cartel cannot be effective in controlling world markets until competition in domestic markets has been eliminated. If an American corporation agrees with a German, a French, a British, and a Japanese corporation to allot world markets before each has been firmly intrenched at home, all markets are made insecure by domestic competitors. Control of domestic markets may be established through control of patents, secret processes of manufacture, or deposits of raw materials which are to be found in a relatively small number of countries, or the cultivation of a plant or tree which is indigenous to a country or which thrives in few countries. Examples of international cartels which depend for their success upon the control of patents are radios, electrical equipment, optical glasses, and rangefinders for battleships. Secret processes as well as patents have been effective in dyestuffs, synthetic rubber, and certain branches of the chemical industries. Cartels whose power depends upon control of deposits of raw materials have been formed in such industries as tin, aluminum, copper, nickel, industrial and gem diamonds, and natural nitrates. Cartels controlling the supply of a product which can be successfully grown in a small number of

countries are those in natural rubber, tea, and cinchona bark from which quinine is made.

At the beginning of the Second World War, there were at least 175 international cartel agreements controlling the production and marketing of essential commodities.[4] Many of these agreements were nullified, so far as participation by American corporations were concerned, by action of the United States Government after our entry into the war. Many of them continued throughout the war period, either because the cartel was controlled by corporations outside the United States or because the government for one reason or another was unable to bring the participants to trial.

The dyestuff industry has been controlled by a cartel dominated by Germany. Manufacturers of dyes in the United States are the General Aniline Works, Inc., Allied Chemical and Dye Corporation, E. I. du Pont de Nemours and Company, and six somewhat lesser-known companies.[5] The largest producer of dyes and chemicals in the world before the war was the I. G. Farben company of Germany. Of the other members of the cartel, three were located in Switzerland, one in England, one in France, one in Japan, and one in Canada. These companies operate in South America and elsewhere either directly or through corporations controlled by them. I. G. Farben and also the three Swiss companies each controlled corporations in the United States which they used as their sales agents, and the Swiss companies owned jointly the Cincinnati Chemical Works, Inc., a large producer in this country. In 1941, I. G. Farben acquired 51 per cent of the stock of the only large dye manufacturer in France.

In 1929, an agreement was reached by I. G. Farben, the three Swiss companies, and the French corporation for the formation of the Continental Dye Cartel, which was dominated by I. G. Farben. The English corporation became a member in 1931. The cartel had as its purposes: the protection of the home markets of the members, the allocation of markets in other countries, the establishment of quotas, and the fixing of prices. Later the du Pont Company became a member as a result of its agreement with the English company by which the du Pont Company agreed not to export dyestuffs to the British Empire and to limit production in

[4] Wendell Berge: "Antitrust Enforcement in the War and Postwar Period," *George Washington Law Review*, June, 1944, Vol. 12, pp. 371-412.

[5] Data on cartel in dyestuff industry from indictment of Allied Chemical and Dye Corporation *et al.*, May 14, 1942.

other markets. The English company sold the du Pont Company its dyestuff business in the United States in exchange for du Pont's business and dyestuff properties in India. Later du Pont entered into an agreement with I. G. Farben which provided for the establishment of uniform sales policies relating to sales in the United States and for the elimination of competition in other countries. The agreements were extended from time to time. The du Pont Company and the Allied Chemical and Dye Corporation entered into agreements with the Mitsui Trading Company of Japan allocating markets in China and other countries, fixing prices, and limiting production. Agreements of a similar nature were entered into by various other companies. The agreements were continued in effect until the Japanese attacked the United States in December, 1941, but were later abrogated through action of the government.

The production of magnesium was controlled by a cartel prior to the Second World War. Magnesium, a metal which is one-third lighter than aluminum, is a strategic material much used during the war. It is important as an alloy for airplane production. It is also a valuable incendiary agent in the manufacture of flares, tracer ammunition, incendiary bombs, flash-light powder, and flash bulbs. All production in the United States prior to the war was by Dow Chemical Company. The American Magnesium Corporation, the largest fabricator of magnesium products in the United States, was formed in 1932 by the Aluminum Company of America and I. G. Farben of Germany.[6] It acquired patents for the manufacture of magnesium products formerly owned by the two companies who organized it. In this way, the patents were pooled. The American Magnesium Corporation then entered into a magnesium contract with Dow Chemical Company, and as a result of that contract all fabricators of magnesium were required to purchase their magnesium for manufacturing purposes from the Dow Chemical Company. That was the only way they could be granted permission to use the patents of I. G. Farben and the Aluminum Company of America. In this way the amount of magnesium manufactured in the United States was kept at a small amount. The agreement continued in effect until it was set aside by order of the government early in the war.

World trade in optical instruments has been controlled by a

[6] Indictment of Dow Chemical Company *et al.*, January 30, 1941.

cartel agreement between two companies. The two companies controlling the production and sale of optical lenses, used for eyeglasses, cameras, rangefinders for artillery, periscopes, torpedo directors, bombsights, and other similar purposes are Bausch and Lomb Optical Company, an American company with a factory at Rochester, New York, and Carl Zeiss, a German company. Zeiss had a subsidiary in Holland and another, Carl Zeiss, Inc., in the United States.[7] In 1921, Bausch and Lomb entered into an agreement with Zeiss dividing world markets between the two companies. Bausch and Lomb was given the exclusive rights to sell in the United States and Zeiss was given the rest of the world. Each company agreed not to sell in the territory of the other without permission. Sales made by one company in the territory of the other were to be made at prices agreed upon by the two companies. Each company agreed not to license any other person or corporation to use its patents for production and sale in the territory of the other. Bausch and Lomb also agreed to pay a royalty to Zeiss on all optical equipment sold to the United States Government regardless of whether the equipment was produced under patents owned by Zeiss. To assure that one company would not encroach upon business in territories assigned to the other, the two companies agreed in 1925 to add twenty per cent to the regular price on all bids submitted to prospective purchasers in the territory of the other company. If a company should receive a contract despite such addition, the twenty per cent was to be paid by the successful bidder to the other party. This agreement was continued until it was set aside by order of the government in 1940.[8]

World markets in electric lamps are controlled by a few corporations through patent licensing agreements. In the United States the production of electric lamps and tubing used in special types of lighting equipment is dominated by the General Electric Company, Westinghouse Electric and Manufacturing Company, and Corning Glass Works. Control was established through patents for electric lamps owned by General Electric Company and patents for the manufacture of glass bulbs, glass tubing, and cane, owned by Corning. Although many of the patents have expired, the grip of the two companies has not been relaxed.[9] Agreements between the patentees and manufacturing companies have had a long his-

[7] Indictment of Bausch and Lomb Optical Co. *et al.*, March 26, 1940.

[8] Consent decree, District Court, S.D., N.Y.

[9] Complaint against General Electric Co. *et al.*, 1941.

tory, as they date from 1896. The agreements, renewed and modified from time to time, have permitted the licensees to use patents owned principally by General Electric and Corning but have required the payment of royalties and the observance of scheduled prices and production quotas.

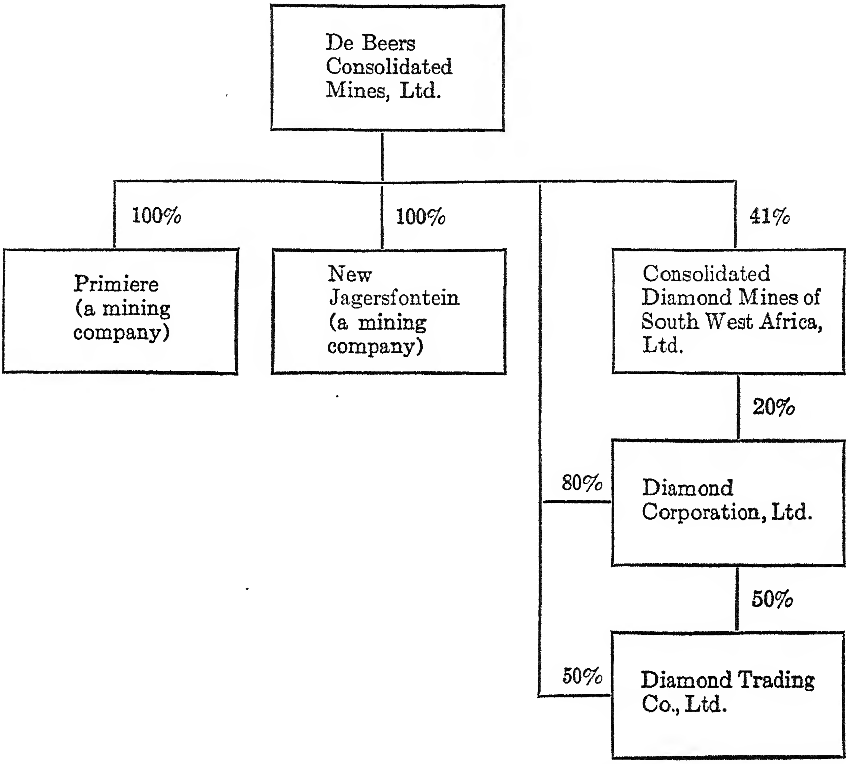
Beginning about 1927 General Electric and Corning entered into exclusive licensing agreements with dominant lamp manufacturers in France, Germany, Mexico, Holland, Hungary, England, and Japan. The purpose of the contracts was to provide for an exchange of patent rights relating to the manufacture of lamps and to allot territory. The United States market is reserved for General Electric Company and its licensees and the foreign territory is reserved for the foreign corporation. Certain neutral territory is open for sales by either party. General Electric Company has increased its influence over foreign markets by acquiring substantial blocks of stocks in several foreign lamp manufacturing and selling companies.

The diamond market has been effectively controlled by an international cartel. The diamond industry produces three important materials: gem diamonds, industrial diamonds, and boart.[10] Gem diamonds for rings and other ornaments are the choice products of the industry. Industrial diamonds are used for cutting, grinding, and boring hard materials such as metals and stone. They form the abrasive feature of diamond drills, saws, shaping tools, and gear grinders. Boart is a diamondtine substance containing impurities. Its uses are similar to those of industrial diamonds. Eighty per cent, by weight, of the world's production of diamonds is used for industrial purposes.

The diamond deposits of the world are limited to South Africa, the Belgian Congo, Portuguese Angola, Gold Coast, and Sierra Leone, with a few minor deposits in other parts of Africa and South America. The largest diamond mining company is De Beers Consolidated Mines, Ltd. which was organized in 1888 under the laws of South Africa. Other deposits in South Africa are controlled by Consolidated Diamond Mines of South West Africa, Ltd., in which De Beers has a 41 per cent interest. These two companies control the Diamond Corporation, Ltd. which buys and stores diamonds to aid in the control of supplies and sales. Sales are made only through the Diamond Trading Company, Ltd., which is owned

[10] Data on diamond cartel from complaint by Department of Justice against De Beers Consolidated Mines, Ltd., *et al.*, 1945.

jointly by the Diamond Corporation and De Beers. The intercorporate relationships are shown in the accompanying chart.



Organization of Diamond Companies in South Africa

The diamond deposits in the Belgian Congo, the Gold Coast, Portuguese Angola, and Sierra Leone are in each country owned by one large corporation either directly or through other corporations. The deposits in the Belgian Congo are owned by Société Minere du Beceka, which is in turn controlled by the Société Générale de Belgique, a giant corporation owning seventy per cent of the industrial enterprises in Belgium in addition to fifty per cent of the mining, power, and raw materials in the Congo.

Some time prior to 1920, the producers of diamonds in South Africa and South West Africa agreed to monopolize the supply of diamonds in world markets and for this purpose formed an association known as the Conference. They agreed to limit production and to sell exclusively to a group of London merchants known as the Diamond Syndicate. Later as the mines in other parts of Africa

were brought into production, the Conference entered into agreements with them which continued the centralized control of diamond sales. The agreements required each mine to sell its diamonds exclusively to the Diamond Syndicate. The Syndicate limited its sales in order to hold up the price and in time became overstocked. In 1929 the Conference Producers bought back half of the diamonds held by the Syndicate to assist in supporting the market. In 1930 the Diamond Corporation, Ltd., was organized to buy and hold all excess stocks of diamonds. In 1933 the Diamond Trading Company was organized to act as exclusive sales agent, thus replacing the Syndicate. This arrangement, with slight modifications, has been continued since that time.

The companies composing the diamond cartel assign quotas to each mine. The amount which each is permitted to produce is designed to replace quantities of industrial and gem diamonds sold by the Diamond Trading Company in world markets. Although the quotas limit only the gem diamonds and not the industrial diamonds to be produced, the production of industrial diamonds and boart is indirectly controlled because all diamonds are obtained from the same deposits. Production permitted throughout the Second World War was far less than sales. The difference was withdrawn from stocks previously produced and held off the markets to enhance prices.

Sales of gem diamonds are made by the Diamond Trading Company on only four occasions during the year. At the sales or "sights," which are held in London, only a few dealers are admitted and each dealer must buy at least £20,000 worth. All purchases must be paid for in advance. Diamonds are sold in lots made up by the company, and each lot contains a wide variety of sizes and qualities. No selections within lots and no returns are permitted. Industrial diamonds and boart are also sold in lots with no permission to inspect, no guarantees, no returns, and no allowances. If a buyer is dissatisfied, his only recourse is to retire from business and to discontinue his purchases.

To induce purchases of gems, the cartel has carried on a continuous campaign of advertising which is designed to convince the public that diamonds are naturally rare and valuable and inherently worth the prices asked. Pressure is brought upon magazines to induce them not to allow publicity which would be unfavorable to the cartel. The arrangement has been eminently successful for the members. De Beers Consolidated Mines, Ltd., pays forty per cent

dividends on its preferred stock and earns fifty to one hundred per cent on its common stock.

A tin cartel has been organized with government support. The production of tin is controlled by a relatively small number of companies which own the deposits located in the Malay States, the Dutch East Indies, Bolivia, and Nigeria. In 1929, the mine owners undertook to form a cartel to control production and prices, but they failed because of differences of opinion and lack of authority to require the observance of the quotas allotted. In 1931, the governments of British Malaya, the Dutch East Indies, Bolivia, and Nigeria set up an International Tin Committee with authority to control the production of tin. The Committee is authorized to determine the total quantity of world production and to apportion that amount among the various countries. Each country in turn assigns a quota to each producer within the country. Plans were also perfected for a gradual and orderly disposal of reserve stocks which had been built up in previous periods of uncontrolled production. Prices of tin were stabilized and production was substantially reduced. The Committee continued to function throughout the war despite the invasion of the Malay States and the East Indies by the Japanese. It fixed and assigned quotas even though most of the sources of supply were cut off.[11]

III. Some Economic Problems of Cartels

The economic and social effects of cartels have been the subject of much discussion, and there are many points of view concerning them. All that can be done here is to point out some of the problems which they have created. The future development of cartels will depend upon the extent of state control exercised over them and the wisdom displayed by government officers who supervise them.

The cartel permits of a regulated economy within the capitalist system. The national cartel system affords a means of permitting private ownership with state control of industry. (It makes possible the direction of the economy in the interests of the people as a whole.) The expansion or contraction of industry, the profits of private business, the prices of raw materials and finished goods, the wages of workers, and other aspects of the economic system may

[11] Corwin D. Edwards, *Economic and Social Aspects of Cartels,* Publication of Committee on Military Affairs, U.S. Senate, Washington, 1944.

be regulated to promote the public welfare. A state may employ the cartel system to regulate some industries which are monopolistic or otherwise affected with a public interest, while other industries which are regarded as essentially competitive may remain unorganized and outside the scope of cartel and state control.

The national cartel system may be used to move the economy gradually toward socialism. Through the control of prices of raw materials and finished goods and also of wages, the private manufacturer may be allowed a wide or a small margin of profit as the state considers desirable. Private manufacturers may be caught in the squeeze effected by rising costs and declining prices of the products of industry. The margin of profits may be gradually narrowed until the profit motive has largely or entirely disappeared. In the absence of effective state control, however, the cartel system may be used to widen the margin of profit at the expense of wage-earners and consumers and to effect a redistribution of the national income in favor of capital.

The cartel system may result in greater stability of commodity prices. (Cartels have usually been organized in periods of depression when the volume of business has slackened and the struggle for orders has intensified. The objective is the prevention of further price declines, and a successful cartel will be able to resist extreme price reductions.) When business begins to revive, the prices of the products of cartelized industries are usually slower to advance because they do not have to recover lost ground. While rapid advances in prices are usually not experienced in such industries, the level is likely to be higher than it would be without the cartel. The higher level of prices which may be maintained for long periods of time in some cases such as rubber has resulted in an overexpansion of the productive capacity of the industry which in turn has caused the disintegration of the cartel.

If it be admitted that cartels prevent extreme fluctuations in prices either upward or downward, there remains the question whether price stability is desirable. In a capitalist economy, price declines serve to stimulate demand and to discourage further investment in the industry. Price advances serve to decrease effective demand and to bring about further production of capital equipment. While the investment of capital in an industry cannot be readily withdrawn or converted to other uses when profits vanish as a result of declines in prices, expansion may be discouraged and the replacement of worn-out equipment may be prevented. If

some industries are controlled by cartels while others are not, the prices of different commodities as well as the rate of expansion of different industries may become maladjusted with resulting inefficiencies in the economic system. The stability of prices in cartelized industries also introduces an element of rigidity by fixing the costs of manufacturers who use such products as their raw materials. If the raw material costs of subsequent processors become fixed through the stabilizing activities of cartels, other parts of the economic system may thus become stabilized and unable to react to variations in consumer demand. The result is a system which fails to respond readily and smoothly to inevitable disturbances.

The cartel system may result in overexpansion of plant capacity in the cartelized industries. In the absence of effective state control, the prices fixed by the cartel are monopoly prices. Such prices are not necessarily higher then competitive prices because the cartel may be able to eliminate certain selling costs of the members, but they are likely to be higher and in any case they are artificially fixed. Monopoly prices offer an inducement to members of the industry to increase plant capacity which is already adequate, in order that they may have an effective argument for an increase in sales quotas during the next year. Furthermore, monopoly prices usually result in increased profits, and experience indicates that when profits are large, a substantial percentage of them is reinvested in the industry. Thus, the cartelized industries may overexpand, and the use of capital in such industries means less capital for other industries. While this undesirable result may be avoided by wise cartel or state control, it is likely to result if control is unwise or ineffective.

Wages may be increased as a result of cartel control. Cartels frequently have been able to increase wages because they can pass the higher wage costs along to consumers in the higher prices. If workers are well organized, the cartel may find it easier to raise prices than to resist the demands of the union. This was true in Germany prior to the advent of National Socialism, at least for some industries, and the workers frequently lent their support to the control of an industry by a cartel. The cartel may answer any criticism of prices charged by the argument that a decline of prices will necessitate a decrease in wages.

The national cartel system frequently results in dumping. Dumping is the sale of a product abroad at lower prices than are charged at home. The cartel makes this possible because it can fix

domestic prices by agreement. The government may assist in the control of the home market by tariffs and import restrictions, and further protection is afforded by transportation costs. The cartel sells all that it can at home at the prices agreed upon, and any surplus is sold abroad for what it will bring. This policy has disastrous effects upon industry in the country where the surplus is dumped because the quantity sold there is subject to extreme fluctuations. In some years the quantities dumped are so great and the prices charged are so low as to bring ruin to manufacturers in the foreign country.

International cartels have not been subject to effective state control by countries other than Germany. Countries such as the United States have not undertaken an effective control of international cartel agreements, and the existence of many restrictive contracts was not known to the government until they were disclosed by the Department of Justice. The result was that the German Government was able to use international cartels for its own nationalistic purposes and especially in its military program. Private corporations in the United States have been willing participants in the plans because of their conviction that such arrangements were no more than private business transactions. This view was stated by the chairman of the board of General Motors Corporation who declared that "an international business operating throughout the world should conduct its operations in strictly business terms without regard to the political beliefs of the country in which it is operating."[12] The opposite view was expressed by the head of a German corporation, who said, "An international cartel has no right of existence and a German businessman has no right to become a member of such a cartel if this cartel is acting against the common interests of Germany."

International cartels used their power to prevent military preparedness in the United States. The influence of international cartels upon the military preparedness of the United States prior to 1940 was exerted in several directions.[13] The production in the United States of many products essential for war was either prevented or limited by cartel agreements. This was true of synthetic nitrogen and other chemicals, zinc, magnesium, aluminum, and

[12] As quoted by Corwin D. Edwards: "International Cartels as Obstacles to International Trade," *Amer. Ec. Rev.*, Supp., Vol. 24, p. 335, Mar., 1944.

[13] For full discussion of this point, see Corwin D. Edwards: *Economic and Political Aspects of International Cartels,* Government Printing Office, Washington, 1944.

optical instruments. Research in certain fields and the commercial application of technological progress by corporations in the United States were discouraged in such fields as chemistry, electrical appliances, synthetic oil, synthetic rubber, and Diesel engines. In synthetic rubber, the Standard Oil Company (N.J.) gave I. G. Farben full technical information concerning its butyl rubber in 1938 but was not given the rights to the use of I. G. Farben's patents until 1940. Even after that time, it was required to develop the manufacturing processes without any assistance from I. G. Farben.[14] Other companies were denied the right to use the patents until 1942 when Standard Oil was required by court decree to grant unrestricted licenses without royalties for the duration of the war.

International cartels have used their power to increase prices and to deteriorate quality. When markets are divided territorially, the company which is assigned a territory is free to increase its prices and also to deteriorate quality in order to reduce costs or to increase sales by shortening the life of the product. When two or a few companies are assigned a territory, they may enter into agreements with each other to fix prices or to lower quality. This has been true in the manufacture and sale of electric light bulbs. The diamond cartel has increased prices and also forced worthless industrial diamonds and imperfect gems upon purchasers.

The division of territories by members of cartels frequently runs counter to the policies of the government. In the division of markets by international cartels, the United States and perhaps an additional share of North America are usually assigned to manufacturers in the United States, while the South American market along with the European, is assigned to manufacturers in Europe. Such an agreement excludes American companies from South America as effectively as would a high discriminatory tariff against our products to which our government would certainly protest in most vigorous fashion. It lessens the industrial ties between North and South America at a time when the government may be attempting by trade agreements and otherwise to build up a solidarity between the Americas. Such an agreement may also cause resentment against the United States because the company in the United States has made consumers in South America the victims of the cartel. In some smaller South American countries, the European

[14] *Ibid.*, pp. 58-60.

member of the cartel has been placed in a position where it can exert great political influence.

International cartels must be either prevented or brought under close supervision by the government. The policy which the United States pursued before the war of permitting cartel agreements to be entered into secretly and without government supervision cannot be followed in the post-war era. At present our efforts are being directed at forcing American corporations to cease their participation in such agreements because they are a violation of the antitrust laws. This procedure does not seem to constitute a complete solution of the problem so long as cartels are permitted abroad and American corporations must compete with them in the markets of the world. The problem cannot be easily handled by any one country but should be controlled through international agreement. So far as Germany is concerned, an agreement was reached by the United States, Russia, and Great Britain at the Potsdam (Germany) Conference in July, 1945. The report on the Tripartite Conference which was released early in August stated:

"At the earliest practicable date, the German economy shall be decentralized for the purpose of eliminating the present excessive concentration of economic power as exemplified in particular by cartels, syndicates, trusts and other monopolistic agreements."

Questions

1. What is the difference between a cartel and a pool?
2. What is the historical explanation for the development of cartels in Germany?
3. Why does the cartel become more important in a period of depression than in a period of prosperity?
4. What factors contributed to the development of cartels during the decade of the 1870's.
5. How did the German Government attempt to regulate cartels prior to the First World War?
6. Compare the cartel with the trade association in the aid it can render to the government in wartime.
7. Why did the cartel almost disappear in Germany during the period of monetary inflation in 1922 and 1923?
8. What was the purpose of the cartel court?
9. What types of activity are carried on by a cartel?
10. What is a regional cartel?

11. How did the free trade policy of Great Britain affect the development of cartels in that country?

12. Why is control of the domestic market necessary before an international cartel can expect to be successful? How is control of the domestic market effected?

13. Why should such products as dyestuffs, magnesium, aluminum, and optical instruments have been made the subject of international cartel agreements?

14. What are the advantages to an American corporation of an agreement dividing markets when its exports are limited or prohibited?

15. How is the diamond industry controlled through international cartel agreement?

16. Is the intrinsic value of diamonds enhanced by a reduction in the supply of them sold in the markets of the world? If you were the owner of a number of gems, would you favor continued control of the industry by the cartel?

17. How can the national cartel system be used to effect a redistribution of wealth and income within a nation? Is this a desirable objective?

18. Is the stability of the price level desirable? What economic advantages are gained by price fluctuations? What are the objections to price fluctuations?

19. How does the cartel system affect the expansion of plant capacity of a country?

20. How does the cartel system affect wages? Does the answer depend in part upon what control over cartels is exercised by the government?

21. What is dumping? Why does the cartel system often result in dumping?

22. Should not a country be pleased to purchase its requirements of manufactured goods abroad at very low prices? If so, why is dumping objectionable?

23. Contrast the policy of the United States concerning international cartels with the policy of Germany.

24. How do cartel agreements sometimes run counter to the policies of the government in its dealings with foreign governments?

25. What should be the policy of the United States regarding international cartels in the future?

CHAPTER XXI

The Trust

The trust, or trustee device, was first used in 1879, when the Standard Oil Trust was organized. The idea of the trustee device is said to have originated with Mr. S. T. C. Dodd, the solicitor of the Standard Oil Company of Ohio. The Standard Oil Trust was reorganized in 1882 to include additional companies, and during the next few years the trust form of organization was adopted in a number of other industries. The Cotton Seed Oil Trust, or simply the Cotton Oil Trust, was organized in 1884, and the Linseed Oil Trust in 1885. The Whisky Trust, officially known as the Distillers' and Cattle Feeders' Trust, and the Lead Trust and the Sugar Trust were organized in 1887. Many other industries were reported to be controlled by trusts, but because of the secrecy surrounding them, it is difficult to determine to just what extent trust agreements were made. A further difficulty is that even as early as 1888 the word *trust* was frequently used to designate any combination, regardless of the form of organization.

The trust must be distinguished from the business trust described in Chapter V. The assets of the business trust consist of plant and equipment used in production or, in some business trusts, the securities of other companies; but if the securities consist of stocks, they do not include a controlling interest in more than one company. If a business trust owns all or a majority of the stock of two or more companies, it becomes a trust in the sense in which the word is used in the present chapter and is an illegal form of organization.

The trust was abandoned about 1892 as a form of combination because of the successful legal attacks which had been made upon it, but it has been of such great importance as to warrant our study. It was one of the early forms of organization used to effect a permanent and close combination of competing companies, and it was the forerunner of the present-day holding company. Holding companies were known prior to the eighties, but they were

restricted by law. Less than a decade after the trustee device had been abandoned, the holding company took its place.

I. The Organization of the Trust

All of the trusts were similar in organization because most of them were modeled on the Standard Oil Trust of 1882. In describing the organization of the trust, we shall therefore describe the Standard Oil Trust and shall make only incidental reference to the other trusts.

The trust agreement provided that the stocks of various companies should be transferred to trustees. In the oil-trust agreement, forty corporations and limited partnerships and a long list of individual owners were included. The stocks of the various companies were delivered to nine trustees in exchange for trust certificates, and they were then transferred to the trustees on the books of the various corporations. The trustees thereby acquired all of the rights of stockholders, including the rights to vote the stock, to subscribe to additional shares, and to receive dividends. As for the property of the individual owners and the limited partnerships, it was provided that four Standard Oil corporations should take over the assets. The Standard Oil Company of Ohio was already in existence, and three new companies were formed, one each in New York, Pennsylvania, and New Jersey. The newly organized companies issued their stocks at par in exchange for the oil properties, which were taken over at an appraised value. The stocks were first issued to the owners of the property, who in turn delivered them to the trustees to be held by them and their successors.

When the Sugar Trust, which was officially known as the Sugar Refineries Company, was formed, the stocks of the fourteen refining companies were turned over to eleven trustees. The members which were not already corporations agreed to form corporations to take over their assets and to transfer the stock to the trustees. The trustees of the Sugar Trust held office for seven years, as compared with a term of nine years for trustees of the Oil Trust. In both cases the trustees were divided into classes, with the terms of the different classes expiring in different years.

The trustees were given broad powers. The trustees could pay the dividends received from the various companies to the holders of the trust certificates, or they could use any or all of the money to purchase the stocks of other companies. The trustees of the Oil

Trust did, in fact, acquire the stocks of at least 78 more companies during the ten years the trust agreement was in force. During that same time they dismantled about fifty refineries. New companies were organized and various companies were merged, with the result that the companies composing the trust were changed greatly during its life.

The trustees were empowered to make loans to any of the companies and to purchase their bonds. Since they controlled the boards of directors of various companies composing the trust, they could declare whatever dividends on their stocks they chose to declare. As voting stockholders, they elected the directors of the various companies. They could elect themselves as directors, and at least one trustee was a member of the board of each company; and in order to permit other persons to qualify as directors, the trustees were empowered to assign whatever stocks might be necessary. They received frequent reports from each company, and they decided upon prices, output, and other business policies.

The trust certificate represented an interest in the trust fund. The par value of the trust certificates was $100. All trust certificates in the same trust were alike and had the same voting rights, the same interest in the assets of the trust fund, and the same rights as to dividends, regardless of the stocks given in exchange for them. In other words, the stocks of the various companies were merged in a common trust fund, ownership in which was represented by trust certificates. The certificates were bought and sold just as is the stock of a corporation.

The certificate holders elected the trustees at an annual meeting. Holders of certificates might vote in person or by proxy, each share having one vote. The method of calling the meeting, the procedure at the meeting, and the powers of the certificate holders were prescribed in the trust agreement.

The trust agreement was intended to be a permanent arrangement. The usual provision was that the trust should continue until 21 years after the death of the last surviving trustee named in the trust agreement. It was provided, however, that by vote of the holders of the certificates the trust might be terminated sooner. The oil trust could be terminated after one year by a vote of 90 per cent of the holders; after 10 years, by two-thirds of the holders.

The trusts achieved a virtual monopoly. The Oil Trust did not control all of the oil refineries in the United States, since about 100

Number...... SHARES $100 EACH Shares......

STANDARD OIL TRUST

This is to certify that .... is entitled to ...... shares in the equity to the property held by the trustees of the Standard Oil Trust, transferable only on the books of said trustees on surrender of this certificate. This certificate is issued upon condition that the holder or any transferee thereto shall be subject to all the provisions of the agreement creating said trust and of the by-laws adopted in pursuance of said agreement as fully as if he had signed the trust agreement.

Witness the hands of the president, secretary, and treasurer of the board of trustees this .... day of .... A.D. 188 .... at the city of New York.

J. D. Rockefeller, President
H. M. Flagler, Secretary
William T. Wardwell, Asst. Treasurer

Form of Oil Trust Certificate

concerns competed with it, but it took in most of the larger companies, and its refineries produced more than 75 per cent of the output of oil in the United States. This was a sufficiently large percentage to enable it to control prices within certain limits, by increasing or decreasing the supply of oil placed upon the market. The Oil Trust, like all other combinations, was always subject to

For value received .... do hereby assign, transfer and set over unto .... shares of those represented by the within certificate, and .... do hereby constitute and appoint .... attorney, irrevocable, for .... and in .... name and stead, to transfer the said shares upon the books kept for the purpose under the direction of the within board.

The assignee by accepting this transfer assents to the terms of the deed referred to in the certificate as the same shall be changed from time to time.

Witness hand and seal this .... day of .... 188....

....

Reverse Side of Trust Certificate

the possibility that new competitors might enter the field, but potential competition was not enough to protect the public from monopolistic control of prices. A large amount of capital was required to build a refinery and to construct pipe lines, and businessmen naturally hesitated to enter a field which was known to be controlled by a trust. The fear of the trust, moreover, was in-

creased by the fact that it was known to use unfair methods of competition and that it dealt mercilessly with its competitors.[1]

The success of the Oil Trust is indicated by its profits. Besides paying high rates of dividends, it increased the value of its property from $75,000,000 in 1882 to about $121,000,000 in 1892. Of this increase, fifty per cent came from profits, and the remainder from additional capital subscribed by various classes of security holders and from refineries purchased by the issue of trust certificates.

The Sugar Trust, like the Oil Trust, controlled such a large percentage of the total output that it could fix the price of sugar almost as it pleased. Since it controlled from 85 to 95 per cent of the output of sugar, any limitation upon its control of the market came largely from the fear of potential competition rather than from actual competition. The Whisky Trust included 75 or 80 distilleries north of the Ohio River. The total number of distilleries in that section of the country at that time was estimated to be 90 to 100.

II. The Illegality of the Trust

The principal trusts were dissolved during the early nineties, after several of the states had been successful in their suits against member corporations. The Sugar Trust was dissolved in 1890 as a result of a suit by the state of New York against the North River Sugar Refining Company.[2] The Oil Trust was dissolved in 1892 after a suit by the state of Ohio against the Standard Oil Company of Ohio.[3] The Whisky Trust was dissolved by the state of Nebraska,[4] and the Cotton Oil Trust by Tennessee.[5]

The promoters believed the trusts to be legal. It was contended that neither the trustees nor the corporations in the trust could be attacked on legal grounds for the reason that only the stockholders had entered into the agreement. The trustees acted merely as stockholders. Their function was to elect directors for the cor-

[1] For a description of the competitive practices of the early Standard Oil combination, see Volume I of the report of the Industrial Commission (1900), pp. 261-812, particularly the testimony of M. L. Lockwood, Thomas W. Phillips, W. H. Clark, and Theodore Westgate.

[2] People *v.* North River Sugar Refining Co., 121 N.Y. 582, 24 N.E. 834 (1890).

[3] State *v.* Standard Oil Co. of Ohio, 49 Ohio 137, 30 N.E. 279 (1892).

[4] State *v.* Nebraska Distilling Co., 29 Neb. 700, 46 N.W. 155 (1890).

[5] Mallory *v.* Hananer Oil Works, 85 S.W. 396 (Tenn., 1888).

porations, to receive dividends on the stock, and to pay the dividends to the holders of the trust certificates. When they regulated prices and production policies, they acted in their capacity as directors and not as trustees.

The trust was held to be a partnership of corporations. It was on this ground that the trusts were held to be illegal. Since a corporation has no implied authority to enter a partnership, the corporations whose stocks were controlled by the trust were held to have exceeded their powers and to have violated the terms of their franchises by becoming members of the trust. In the case involving the Cotton Oil Trust, for example, it was stated by the court that the trust was a partnership because the trust agreement conveyed the beneficial use of the corporate property to the trust and left nothing to the "several corporations but the right to receive a share of the profits and participate in the management and control of the consolidated interests as members of the new association." It substituted the trustees as governing bodies and made the directors mere tools of the trustees; and this arrangement, the court said, was wholly inconsistent with the scope and tenor of the powers expressly conferred upon the corporation and the duties imposed upon it.[6] If a corporation is a member of a partnership, it may be bound by contracts made by other members of the association, whereas the whole policy of the law creating and regulating corporations looks to the exclusive management of the affairs of each corporation by its officers. This management must be exclusive, and any arrangement by which the control of the affairs of the corporation is taken from the directors and officers is opposed by the general policy of the incorporation act.

The courts refused to make a distinction between the acts of the stockholders and the acts of the corporation. It was held that when the whole body of officers and stockholders participate in an act, their conduct may assume corporate character, and if such action is illegal and injurious, the corporation may suffer the penalty of dissolution. The directors had also erred in recognizing the illegal transfer of the stock to the trust.[7]

The trust was illegal also because it constituted a monopoly. The decisions were rendered primarily on the ground that the trust was a partnership, but in several cases the courts referred to the fact that monopolies were opposed to the public interest and

[6] *Ibid.*, 85 S.W. 396, 399.

[7] People *v.* North River Sugar Refining Company, 24 N.E. 834, 839.

intimated that the trusts might have been held to be illegal because they were monopolies. In the Sugar Trust case, for example, it was pointed out that the trust form of organization opened an easy road to enormous combinations. The state, by creating the artificial persons constituting the elements of the combination, would become the voluntary cause of aggregations of capital which would be opposed to the public interest. It was considered no answer to say that an individual of wealth might have purchased the stocks of all the corporations composing the trust and thereby have effected a combination of the same magnitude. This would be possible but not likely, and the state had the power to prevent artificial combinations when brought about by corporations with state charters.[8]

The corporations composing the trust were required to surrender their charters or withdraw from the trust. The corporation in each case withdrew from the trust, and this resulted in its dissolution. The combinations were not broken up, however—only the form was changed. The oil industry passed from the control of the trust to the community of interest. The Sugar Trust was changed into a consolidated company. In other instances the trust was changed into a holding company or other form of organization.

III. The Trusts and Social Policy

In considering the desirability of the trust, one must take into account both the individual and the social points of view. The balance of the argument is decidedly against the trust.

The trust has some advantages from the individual point of view. First, the trust offers a permanent form of organization. Most of the forms of organization preceding it, such as gentlemen's agreements and pools, were ineffective because the members could violate the agreement or withdraw at will. The trust could not be terminated by a member.

Second, the trust provided centralized control. The administration of all of the corporations was vested in the trustees and their agents. This made it possible for the trust to achieve many of the economies which are associated with large-scale production. Such economies as the saving of cross-freights, the closing of high-cost plants, the comparison of costs of different plants, the introduc-

[8] See also Distilling and Cattle Feeding Co. *v.* People, 156 Ill. 448; 41 N.E. 188, 201 (1895).

tion of the best production policies in all plants, and the like, could be just as readily accomplished by the trust as by the present-day holding company.

Third, the trust could regulate prices to the advantage of itself and the industry. Most of the trusts were content to restore prices to a moderate level without making them excessive. In fact, those trusts which advanced prices materially soon found that independents entered the field to sell at lower prices and that the sales of the trust declined to such an extent that the profits were less than they would have been had prices not been increased.

The trust may have some social advantages. If the trust did make possible any of the economies of large-scale production, some of the benefits might be expected ultimately to be passed on to the public in the form of lower prices. It is only reasonable to suppose, however, that the principal beneficiaries would be the trustees and the holders of the trust certificates. The trust has been defended on the ground that it produced a superior product. It seems likely, however, that any improvement was a logical development in a new industry.

The trust has serious disadvantages from the individual and the social point of view. The trustees were given much power without being held to account. The trust was not subject to governmental regulation. The trustees were not required to render reports, and the holders of the trust certificates were not kept informed about business affairs. The trust is socially objectionable even though it follows a policy of moderate prices, so long as the prices are higher than they would be under free competition. It is desirable to maintain an open field in industry, free from artificial restraints, which an independent may enter without fear of being crushed by unfair competitive practices.

Questions

1. What was the first trust? When was it organized?
2. How does the trust or trustee device differ from the business trust?
3. What is meant by "the Steel Trust" or "the Harvester Trust"? How did the word trust come to be associated with large size or with monopoly?
4. How was the trust brought into existence? Were all of the members corporations?
5. What were the powers of the trustees?

6. Did the holders of trust certificates have the right to vote? Is this the general rule in business trusts?

7. What was the purpose of the persons who organized the trusts? Did they intend to monopolize the industry or was their objective the accomplishing of some of the savings of large-scale production?

8. On what ground was it argued that the trusts were legal?

9. On what ground were the trusts held to be illegal?

10. Why is a corporation not permitted to become a member of a partnership?

11. Why is the corporation permitted to participate in a joint venture while it cannot be a member of a partnership?

12. How does the owership of all or a controlling interest of the stock of one corporation by another differ from the trustee arrangement?

13. What objection did the courts have to the trusts other than that they were partnerships of corporations?

14. Compare the trust with the corporation which owns a majority of the stock of two or more corporations in the following respects:

a) Name of contract for forming.
b) Persons making the contract to form.
c) Name of shares issued.
d) Name of persons owning shares.
e) What assets consist of.
f) By whom managed.
g) Liability of shareholders.
h) Effect of transfer of shares upon life of the organization.
i) Formed under statute or common law.
j) May or may not have perpetual life.

CHAPTER XXII

The Community of Interest

The community of interest is *a harmonious relationship established between two or more companies as a result of the ownership of their stock by the same persons.* The owners of stock, acting through the boards of directors, coöperate with each other to eliminate competition or to bring about some other arrangement which is in the common interest or in the interest of the owners of the stock.

The community of interest may result from the ownership of less than the controlling interest in the corporations concerned. The ownership of a small amount of stock may be used to secure the election of one or more persons as director for each of the corporations. The directors thus sitting on the boards of the various companies are sometimes able to present the views of each company to the others and to bring about the adoption of policies which are in the common interest. The community of interest may therefore be a close and effective form of organization, or it may be loose and at times quite ineffective.

I. Types of Community of Interest

There are at least three types of community of interest. These are: (1) family groups of corporations, such as the groups controlled by the Rockefeller, the du Pont, and the Mellon families; (2) municipal groups of corporations, centered around the financial interests in a large city such as Boston, Chicago, or Cleveland; and (3) banker groups, dominated by persons affiliated with a large banking house, such as the Morgan and the Kuhn Loeb banks in New York City.[1] In addition to these three types, there are numerous instances of communities of interest between two or more corporations in the same industry or in different industries.

[1] National Resources Committee: *The Structure of the American Economy,* Part I, p. 162 (1939).

A group of corporations has long been controlled by the Rockefeller family. At one time the number of corporations controlled by the Rockefellers was much larger than it is at present. This control dates from 1879 when the first Standard Oil Trust was formed with John D. Rockefeller as one of the nine trustees and a large certificate holder. When the trust was dissolved in 1892, the first community of interest in the oil industry was established. A full compliance with the decree would have required the return of the stocks of the various corporations to the holders of the trust certificates and the cancellation of the voting trust agreement. Instead of doing this, however, the trustees formed a community of interest in this manner. First, they appointed themselves liquidating trustees with authority to wind up the affairs of the trust. Next, they reduced the number of companies whose stocks they held from 84 to 20 by transferring the stock of 64 of the companies to the remaining 20. This left the stock of the 20 companies in their hands for distribution to the certificate holders. Then they announced that they were ready to exchange the stock of these 20 companies for trust certificates, which the holders were asked to surrender; 972,500 trust certificates were outstanding, and each certificate holder was offered his pro rata interest in each of the 20 companies for each certificate which he held. There were two reasons why this plan of dissolution insured that the combination would not really be broken up: first, each of the nine trustees now became a large stockholder in each of the 20 companies, thus establishing a community of interest; and, second, the holders of small blocks of certificates would receive fractional shares of stock in each of the 20 companies. Now, since fractional shares of stock were to receive no dividends, but unsurrendered trust certificates continued to receive dividends, the holders had every reason to keep their certificates. What happened, then, was that the nine trustees surrendered their certificates and established a community of interest among themselves and also continued to act as trustees for the holders of small blocks of certificates which were not surrendered. The community of interest was continued until 1899, when the Standard Oil Company of New Jersey was organized as a holding company to take over the stock of the various companies.

Another community of interest was established in the oil industry in 1911. When the Standard Oil Company of New Jersey was found to be a combination in restraint of trade and was ordered dissolved after a suit under the provisions of the Sherman Antitrust

Act, a community of interest was again established. The stocks of the 33 companies owned by the Standard Oil Company of New Jersey were transferred to the stockholders of that company, leaving the stock of all companies in the hands of the same group of stockholders. The individual units formed as a result of the dissolution did not have common officers or directors, since this was forbidden by the dissolution decree, except for certain pipe-line companies. However, the ownership of stock in the various corporations by the same persons, and the fact that the officers and directors of each of the corporations held substantial blocks of stock in the other companies, made it unlikely that competition would be at once reëstablished. As pointed out in the discussion of gentlemen's agreements, most of the companies have continued to confine their marketing to the territories which were assigned to them before the dissolution of the combination in 1911.

The community of interest of the Rockefeller family now consists of few companies. In 1935 the companies comprising the Rockefeller group included one bank, the Chase National Bank, and six oil companies.[2] The oil companies were Socony Vacuum Oil Co., Standard Oil Company (New Jersey), Standard Oil Company of Indiana, Standard Oil Company of California, Atlantic Oil Company, and Ohio Oil Company. The relatively small number of companies remaining in this group is the result of several developments. The stocks of some of the corporations in the original group have been sold and the stocks of other companies have been purchased because of differences in the comparative values and prices of stocks and for other reasons. Numerous transfers have been made as a result of gifts by members of the family to educational and other institutions. The settlement of estates has caused other transfers to be made. As the industry has expanded and new capital has been required, some of the rights have been sold instead of being taken up by the old shareholders. Interest in real estate developments and other business activities also accounts for a substantial part of the decrease in the number of companies controlled.

The Mellon family group is the largest community of interest based upon family relationships. The companies assigned to the Mellon family group in 1935 included the Mellon National Bank, the Union Trust Company (Pittsburgh), two gas and electric companies, and nine industrial companies. The best known of the industrial companies are the Aluminum Company of America, West-

[2] National Resources Committee: *Op. cit.*, p. 162.

inghouse Electric and Manufacturing Company, Gulf Oil Corporation, and American Rolling Mill Company.

The du Pont family group consists of the National Bank of Detroit and three industrial corporations: the United States Rubber Company, General Motors Corporation, and E. I. du Pont de Nemours and Company.[3]

Family control of large corporations is usually passive rather than active. Groups of large corporations constituting family communities of interest are not managed by members of the family but are administered by professional executives who formulate corporate policies. The control of the family is indirect. It rests upon the power to change the management if profits are inadequate or the policies are displeasing for other reasons. Managements have been displaced on rare occasions, and the fact that they can be changed has its influence upon decisions and policies. An instance of possible family influence on corporate policy is the change by General Motors Corporation to tires made by the United States Rubber Company after the du Pont family had acquired a substantial interest in the two companies.[4] In most cases, however, family control is confined to the power to disapprove objectionable policies. It does not ordinarily extend to the formulation of a positive program of action.

The influence of the family in groups of large corporations is waning. The most important reason for the decline of the family influence is that the founder of the family fortune is no longer living. Ownership is now spread among several persons of the second or the third generation.[5] The present owners do not have the same interest in the affairs of their companies that the original founder had, and in many cases they do not wish to take an active and continuous part in corporate affairs. They are pleased to have others assume the responsibility.

A community of interest may center around a few persons in one city. The large corporations and the banks of a city may be so interlocked through their directorates as to constitute a community of interest. Local manufacturers may serve as directors for the bank, and the bank may be represented on the boards of other corporations. Thus, the bank becomes the focal point for establishing

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[3] *Ibid.*, p. 162.

[4] R. A. Gordon: *Business Leadership in the Large Corporation*, p. 177. Brookings Institution, Washington, 1945.

[5] *Ibid.*, p. 185.

a harmony of interest between financial, industrial, and commercial institutions in the city. The relationship in some cases is fairly close and in other cases is loose.

Groups of communities of interest center in Chicago, Boston, and Cleveland. In 1935 the interlocking directorates in Chicago included eleven closely interlocked corporations. The group included: the First National Bank of Chicago; three trust companies; three public utilities; two meat-packing companies; Marshall Field and Company, a department store; and the International Harvester Company, a manufacturing business. The Boston group is a somewhat smaller but more closely knit group. In 1935 it included: the First National Bank of Boston, Stone and Webster, Inc., United Fruit Company, American Woolen Company, United States Smelting and Refining Company, Edison Electric and Illuminating Company of Boston, and the United Shoe Machinery Corporation. The Cleveland group is the smallest. It is also based upon the smallest number of interlocking directorates. It includes the Cleveland Trust Company and six manufacturing companies.[6]

The community of interest centering around the Morgan bank has existed for many years. Although the corporations composing the Morgan group have changed from year to year, the community of interest has had a continuous existence for at least half a century. Until 1935 it centered around the partnership of J. P. Morgan and Company. It now centers about the two banking corporations bearing the Morgan name. The first comprehensive report on the Morgan companies was in 1913 when a Senate committee[7] found far-reaching interlocking directorates between banks, public-utility corporations, railroads, and manufacturing companies, with the firm of J. P. Morgan and Company occupying a central position. A report in 1933 by another committee of the Senate disclosed that the partners of J. P. Morgan and Company and of Drexel and Company of Philadelphia held 126 directorates in eighty-nine companies having aggregate resources of over twenty billion dollars. The companies included many of the largest corporations in the United States, among them the United States Steel Corporation, the Pullman Company, Texas Gulf Sulphur, Standard Brands, the Baldwin Locomotive Works, the Atchison, Topeka and Santa Fe Railway, and the International Telephone and Telegraph Com-

[6] National Resources Committee: *Op. cit.*, p. 162.

[7] Report of the Committee to Investigate Money and Credit, Feb. 28, 1913.

pany. Some of them, like the United Corporation, were holding companies controlling many other large corporations.

Since 1935 the banking business of the Morgan company has been reorganized. The first change in the Morgan banking interests came in September, 1935, when J. P. Morgan and Company and the related partnership of Drexel and Company formed a corporation under the name of Morgan, Stanley and Co., Inc., to take over the investment banking business formerly conducted by the two partnerships. The partnerships were continued as commercial banks. This action was taken in compliance with the requirements of the Banking Act of 1933 which prohibited one person or institution from engaging in both commercial and investment banking. The new corporation issued both preferred and common stock. The common shares which have sole voting rights were acquired by three former partners in J. P. Morgan and Company and two former partners in Drexel and Company. These five persons withdrew from their former partnership connections. The preferred stock was purchased by officers of the corporation, by partners in the two banking firms, and by members of their immediate families. J. P. Morgan and Company continued as a partnership until 1940 when it was incorporated under the name of J. P. Morgan and Co., Inc.

The reorganization of the banking interests did not terminate the community of interest. According to the Securities and Exchange Commission, a community of interest still exists between the two Morgan banks.[8] This view is based upon the following facts:

1. The personnel of Morgan, Stanley and Co. were selected from the securities department of J. P. Morgan and Company.

2. Morgan, Stanley and Co. took over precisely the business formerly carried on by J. P. Morgan and Company, with the same clients.

3. Controlling stockholders of the two corporations are from the Morgan, the Lamont, and the Leffingwell families. The family holdings, according to the Commission, are a part of the plan to keep the two companies under the same control.

The corporations included in the Morgan group in 1935 were seven banks and trust companies, twelve public utility corporations,

[8] S.E.C. Release No. 15 under Trust Indenture Act of 1939, Sept. 20, 1941.

eleven railroads, and thirteen industrial corporations. The list included many of the largest corporations of the country.

The companies in the Kuhn Loeb interest group are mostly railroads. The Kuhn Loeb group is much smaller than the Morgan group. Besides Kuhn Loeb and Company, the group includes one bank, the Bank of Manhattan Company, and one public utility, the Western Union Telegraph Company. The railroads are thirteen in number, including the Pennsylvania, the New Haven, the Illinois Central, the Union Pacific, and the Southern Pacific. There are of course many interlocking directorates between the companies in the Morgan group and those in the Kuhn Loeb group.

The influence of bankers has been declining since 1933. Although the interlocking directorates have been continued, the influence of the bankers over corporate policy has been steadily declining. One reason has been the series of legislative enactments directed at banking control. The first such law was the Banking Act of 1933 which required that commercial and investment banking be separated. The Securities Act of 1933 brought under Federal control the sale of securities and required among other things the disclosure of the spread between the price paid by the investor for a security and the amount paid to the corporation. A third law was the Public Utility Act of 1935 which gave the Securities and Exchange Commission extensive control over the financial policies of public-utility corporations. A public utility can no longer sell its securities to an investment banker at a price agreed upon by the corporation and the bank but must ask for competitive bids for each new issue and must also have the approval of the Commission before the transaction is consummated. In 1944 the Interstate Commerce Commission ruled that all railroads must also sell their bonds through sealed competitive bids.[9] The influence of the bankers over corporate financial policies was also greatly decreased by the amendments to the Bankruptcy Act in 1935 and 1938 and the Trust Indenture Act of 1939 which were discussed in earlier chapters.

A second factor which has reduced the power of bankers over corporate policy has been a decreasing reliance upon banks for the raising of capital. After the crisis of 1929, corporations ceased to

[9] One of the first men to force the issue of competitive bidding for railroad bonds was Robert R. Young. As a member of the board of the Chesapeake and Ohio, he presented the board with a bid for a bond issue which was $1,350,000 more than the offer of Morgan, Stanley & Co., the traditional bankers of the company. See Matthew Josephson: "The Daring Young Man of Wall Street," *Saturday Evening Post,* Vol. 218, pp. 35, 54, Aug. 25, 1945.

expand rapidly; and such new capital as was required was provided in large part by the reinvestment of profits. There has also been a growing practice of selling high-grade securities directly to large investors, particularly insurance companies and endowed institutions. As industry expanded for war production, a large part of the capital was supplied by the government through the Reconstruction Finance Corporation and other agencies. The result has been a significant decline in the influence of bankers and a marked rise in the power of government.

A community of interest between the Pennsylvania Railroad Company and the Pennroad Corporation was established through a voting trust. The Pennroad Corporation was organized in 1929 by the Pennsylvania Railroad Company. It offered its stockholders the right to subscribe to the stock of the Pennroad, which was to be an investment company and a holding company. A voting trust was established for the Pennroad Corporation naming certain of the directors of the Pennsylvania Railroad the voting trustees for a period of ten years. As a result of this arrangement, most of the stockholders of the railroad company became holders of trust certificates of the Pennroad Corporation, while the directors of the two companies were interlocking. This relationship was established without the necessity for either company's owning stock in the other. Not all of the stockholders of the Pennsylvania Railroad Company became certificate holders in the Pennroad Corporation, since many of them sold their rights to subscribe to certificates in the Pennroad at the time of its organization.

The purpose of the directors of the Pennsylvania Railroad Company in forming the Pennroad Corporation and in establishing a community of interest between the two companies was to strengthen the position of the railroad company in its relations with other railroads connecting with the Pennsylvania. The proceeds of the sale of the trust certificates of the Pennroad were invested in the stock of the Seaboard, the New York, New Haven and Hartford, the Detroit, Toledo and Ironton, and other roads which did not compete with the Pennsylvania but connected with it. One purpose of the Pennsylvania in securing an interest in those roads was to effect an arrangement whereby traffic originating along their lines might be turned over to the Pennsylvania at their terminals instead of being routed over some competing line. A further purpose was to acquire smaller roads which might be made units of a competing

through system if left unattached. A new company was formed because of the legal restrictions upon the right of one railroad company to purchase stock in another.

In 1941 a damage suit was brought by two stockholders of the Pennroad Corporation in behalf of their company and against the Pennsylvania Railroad Company, alleging that the Pennroad Corporation had been mismanaged in the interests of the Pennsylvania Railroad Company. Since the community of interest had disappeared, the Pennroad Corporation joined its stockholders and became a party to the suit. A Delaware court held that the Pennroad Corporation was entitled to damages in the amount of twenty-two million dollars. After motion for appeal had been filed, the two companies made application for a compromise settlement of fifteen million dollars; [10] and in August, 1945, the proposed settlement was approved by the court.

Directors of competing corporations frequently sit on the board of a third corporation in another field. Among the large corporations, directors of the two leading manufacturers of electrical equipment have sat together on the boards of such corporations as the American Telephone and Telegraph Company and the Chase National Bank. Directors of two of the large meat-packing companies have sat on the boards of the International Harvester Company and the Illinois National Bank and Trust Company.[11] Many other examples could be cited. Although the names of the companies change from time to time, the important fact is that such relationships continuously exist. There is no way to determine the extent to which such interlocking directorates affect the policies of the corporations concerned.

Concerns which trade with one another frequently have representatives on the boards of other corporations. Insurance companies which buy securities are widely interlocked with railroads, public utilities, and manufacturing corporations. Purchasers of metals are interlocked with steel and copper companies. Electrical equipment companies have interlocking directorates with public utilities and railroads. A corporation which is thus related to another may or may not have an advantage in the purchase or sale of its goods.

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[10] Statement issued by Pennroad Corporation, March 19, 1945.

[11] T.N.E.C.: Monograph 21, p. 192 (1940).

II. Evaluation of the Community of Interest

In the preceding section some of the facts pertaining to interlocking directorates have been presented without an attempt to decide in every case whether a community of interest exists. In some cases the number of interlocking directors is so great that there can be no doubt of the existence of a community of interests, but in other cases the fact is not so clear.

That a community of interest is established by interlocking directorates has been vigorously denied. Mr. J. P. Morgan [12] said to the Pujo investigating committee in 1913:

> It is shown that 180 bankers and bank directors serve upon the boards of corporations having resources aggregating twenty-five billion dollars, and it is implied that this vast aggregate of the country's wealth is at the disposal of these 180 men. But such an implication rests solely upon the untenable theory that these men, living in different parts of the country, in many cases personally unacquainted with each other, and in most cases associated only in occasional transactions, vote always for the same policies and control with united purposes the directorates of the 132 corporations on which they serve. The testimony failed to establish any concerted policy or harmony of action binding these 180 men together, and as a matter of fact no such policy exists. The absurdity of the assumption of such control becomes more apparent when one considers that on the average these directors represent only one-quarter of the memberships of their boards. It is preposterous to suppose that every "interlocking" director has full control in every organization with which he is connected, and that the majority of directors who are not interlocking are mere figureheads, subject to the will of a small minority of their boards.

In testifying before the Senate Committee on Banking and Currency in May, 1933, J. P. Morgan declared that his banking house did not have a dominating influence upon the policies of the various companies in which the members of his firm were directors. He said that even if the companies were borrowers from the firm, the banking house had no more domination than one vote gave it.[13]

The influence of the interlocking directors cannot be measured by their numbers alone. Although the interlocking directors do not have full control of every organization with which they are connected, it is but reasonable to believe that they have greater influence than their numbers alone might lead one to expect. A director who is a member of a prominent banking house has an im-

[12] Letter of J. P. Morgan: *Report of the Pujo Committee,* pp. 3-26.

[13] *Hearings of U.S. Senate Committee on Banking and Currency,* Part I, p. 33.

portant position because of his control over the extension of credit. In most cases, no doubt, the advice of the banker-director is given honestly in the light of banking and money-market conditions. Corporations desiring to sell bonds or stocks in the market must have a satisfactory record of earnings and dividends, but at the same time it is necessary to protect the solvency and the cash position of the company at all times. Such problems as these the banker understands better than do most members of the board of directors. In view of the company's intimate relations with the bond, stock, and money markets, therefore, the advice of the banker-director is likely to be heeded.

In any group some persons always exert a greater influence than do others. The board of directors is no exception to this rule, and the banker-director is logically the person to whom the other directors might turn. This tendency is greatly increased by the all-too-common practice of naming politicians and others to the boards of directors merely for the advertising which they give to the corporation. These directors, who are not trained in the line of business in which the corporation is engaged, naturally follow the advice of influential persons having their confidence.

The younger J. P. Morgan admitted before the Senate Committee on Banking and Currency that the directorships of his company were not distributed accidentally because of the individual stockholdings of the partners, but that they were assigned in such a way that his firm had representation on the different boards and usually assigned to each company the man who knew the most about that company. He added, however, that it was an advantage to the company to have someone on the board in whom the other directors had confidence, for consultation. Corporate policies are likely to be much affected by the presence of a banker on the board even though the bank does not name a majority of the board.

It is argued that the interest of the banker-director is not personal gain. With regard to the propriety of having a member of a banking house on the board of a railroad, industrial or public-utility corporation, the elder J. P. Morgan said that this practice had been in vogue abroad ever since the creation of limited companies, and that it had arisen not from a desire on the part of the banker to manage the daily affairs of the corporation or to purchase its securities more cheaply than he otherwise could, but rather because of his moral responsibility, as sponsor of the corporation's securities, to keep an eye upon its policies and to protect the inter-

ests of investors in the securities of the corporation. For a private banker to sit on such a directorate, he said, was in most instances a duty and not a privilege. The younger J. P. Morgan said that in his experience of over forty years, he could not remember any of his partners' taking a directorship except at the earnest request of the board of directors of the company in question.[14]

It is no doubt true that security holders expect the bankers to continue to take an interest in the affairs of the corporation after the banking house has disposed of the stocks and bonds to the public. Bankers have frequently been criticized on the ground that they have not directed the affairs of the corporations whose stock and bonds they had previously sold, and that they have allowed the market price of stocks and bonds to take severe declines. One of the criticisms of the corporate system is that promoters transfer their interest in the corporation by selling their stocks, thus permitting the corporation to drift. That bankers continued to safeguard the interests of the holders of stocks and bonds even after they had sold the securities is, therefore, to their credit.

The banker's motive in sitting on the board of directors has not always been impersonal. Besides the fee for attendance at the meeting of the board of directors, there is the advantage to the banking house of acting as fiscal agent for the corporation. One financial service consists of acting as depositary to the corporation; and since some large corporations have cash balances running into the millions of dollars, it is much to the advantage of the bank to receive the deposit account of the corporation. While there are probably good reasons for the keeping of a large cash balance, the small stockholder has sometimes felt that the influence of the banker-director had something to do with it. The banker has also gained by acting as its agent for the payment of dividends and the redemption of bonds and bond coupons.

Contracts between two corporations with common directors are voidable. A director who is also a director of another corporation is not disqualified to vote by virtue of his dual position but his actions may be subjected to close scrutiny to determine whether he has acted in the best interests of his corporation. The usual statutory provision is that the validity of a contract made by two corporations having common directors depends upon its fairness. This type of statute leaves to the courts the question of what constitutes

[14] Opening statement of J. P. Morgan to the Senate Committee on Banking and Currency, May 23, 1933.

fairness and also the question of what influence the interlocking director had upon the rest of the board and upon the final decision. To invalidate a contract, it is necessary to show not only that the transaction is unprofitable to the corporation, but also that it would not have been made without the influence of the interlocking director.

The community of interest is not a desirable method of combination from the business point of view. The community of interest is not a satisfactory form of organization: first, because it is not effective. It does not permit of a unified and businesslike method of organization. Unless the community of interest is complete, it does not make possible the savings that are associated with large-scale production; the most that it can accomplish is the elimination of some of the competitive expenditures such as advertising. Usually, the community of interest does no more than make possible the working out of a harmonious agreement; it does not insure that the agreement will be carried out. Second, the community of interest is not likely to be permanent. Since it is dependent upon the ownership of stock in two or more companies by important financial interests, it may be terminated at any time as a result of the sale of the stock. An organization as uncertain as the community of interest is too unstable to permit of the formulation and execution of important business policies.

The community of interest is objectionable also from a social point of view. Although it may not prove to be permanent, it has sufficient permanence to subject the public to the possibility of monopolistic combination for a limited time. The interlocking directorate creates the danger that one corporation may be exploited in the interest of another, this possibility arising because many of the corporations which have interlocking directors are not competitive but represent different stages in the manufacture of a finished product. Producers of raw material, transportation systems, manufacturers of the finished product, suppliers of power, fuel and communication services—all are interrelated. And because of the wide diffusion of stock ownership and the relatively small amount of stock which directors own, there is always the possibility that the director may profit by having two corporations in which he has an interest make contracts with each other unduly favoring the one in which his interest is the larger.

The community of interest is objectionable also because of the secrecy surrounding it. It is difficult to prove the existence of a

community of interest and to determine who is responsible for any situation. The community of interest is difficult to regulate. From the social point of view it presents some of the most serious problems of all the methods of combination.

Certain types of interlocking directorates are now illegal. As a result of the situation disclosed by the investigation of the Pujo Committee in 1912, the Clayton Act of 1914 prohibited interlocking directorates under certain conditions. It provided that no person should at the same time be a director of more than one bank or trust company organized under the laws of the United States either of which has deposits and capital of more than $5,000,000. A private banker or director of a state bank with capital and surplus of more than $5,000,000 was prohibited from becoming a director of a national bank. The Act also provided that no bank or trust company operating under the laws of the United States in any city of more than 200,000 inhabitants should have as director anyone who was at the same time a director in another bank or trust company in the same city. The Banking Act of 1933, which provided for the separation of commercial banking from investment banking, stated that after January 1, 1934, no officer or director of a bank belonging to the Federal Reserve System could be an officer or director of any corporation or partnership or unincorporated association that is engaged primarily in the business of buying or selling securities or that makes loans secured by stock or bond collateral to any individual or corporation other than its own subsidiaries.

The Clayton Act provided that no person could be a director in two or more corporations which have capital, surplus, and undivided profits of more than $1,000,000 and are engaged in whole or in part in commerce, if such corporations are or have been competitors and if the elimination of competition by agreement between them would constitute a violation of the antitrust laws.

Interlocking directorates among railway companies were made illegal by the Transportation Act of 1920. The Interstate Commerce Commission was, however, authorized to permit any person to serve as director for more than one road if it could be shown that neither public nor private interests would be adversely affected.

The Public Utility Act of 1935 prohibited interlocking directorates between public-utility holding companies or their subsidiaries and banks, trust companies, investment banks, or banking associations or firms; but the Securities and Exchange Commission was authorized to permit such interlocking directorates where they would

not adversely affect the public interest or the interests of investors or consumers. The Federal Water Power Act of 1935 prohibited an officer or director of one public utility from serving as an officer or director of another, and also prohibited interlocking directorates between public utilities and banks, unless the Federal Power Commission expressly authorized a person to serve as officer or director in two or more such corporations.

The prohibition of interlocking directorates has been ineffective. Interlocking directorates between banks have been largely discontinued because the banks have been subject to continuous supervision, but many interlocking directorates between commercial and other corporations have continued to exist. The Federal Trade Commission made an attempt to enforce the provisions of the Clayton Act shortly after the Act was passed, but it soon decided that the community of interest could not be effectively reached by law. The Department of Justice made an attempt to revive the Act in 1935, when complaints were filed against seven individuals and ten competing steel corporations charging that the individuals held interlocking directorships in violation of the Clayton Act. However, most of the interlocking directors resigned all of their positions except one, and the government asked that its petition be dismissed. No attempt to enforce the prohibitions embodied in the Federal Power Act was made for two years; but in September, 1937, the Federal Power Commission announced that it would hold hearings to inquire into the interlocking directorates of certain holding company systems. The interlocking directors who were listed for investigation immediately resigned the majority of their positions. The chairman of the Power Commission stated at that time that some individuals held as many as one hundred interlocking key positions.

One difficulty in prohibiting interlocking directorates is that their existence may be concealed through dummy directors. Persons who control the stock of two or more such companies name their friends or relatives to serve on the boards of directors. This plan may establish a community of interest just as effectively as if one person held all of the positions. One person may himself actually serve as director of two or more corporations; for if suit is brought against him, he has only to resign from the positions complained of and the suit is dropped. To prohibit effectively the building up of a community of interest, it would be necessary to prohibit the ownership of more than certain percentages of the stock of two or more cor-

porations by one person or group of persons. However, a provision of this kind that would be effective and equitable would not only create difficult problems of enforcement but would also be of doubtful constitutionality.

Questions

1. What is a community of interest? How is it made effective?

2. What are the types of community of interest?

3. Is a family usually interested in controlling the policies of a group of corporations or is it interested principally in dividends? May control of a group of corporations be exerted in order to increase dividends?

4. What has caused the decline of family influence in groups of corporations?

5. How does a community of interest in a city originate? What is the purpose of the interlocking directors in bringing about a community of interest?

6. What indications are there that the reorganization of the Morgan interests has not terminated the community of interest?

7. What has a bank to gain from its affiliation with a group of railway, public-utility, and industrial corporations?

8. What has caused the decline of the influence of the bankers since 1933? What influence has replaced it?

9. What was the motive of the Pennsylvania Railroad Company in organizing the Pennroad Corporation? Was the organization of the Pennroad Corporation socially advantageous?

10. How might a community of interest between an insurance company and a group of industrial or other corporations be to the disadvantage of the insurance company? How might it be to the advantage of the insurance company?

11. Might a community of interest between an electrical manufacturer and a public-utility corporation be to the advantage of both corporations?

12. How can a single interlocking director between a bank and an industrial corporation establish a community of interest?

13. Might the banker accept a position as director for an industrial corporation because of a sense of duty?

14. Records show that attendance at meetings of boards of directors is frequently small. Does this fact make it easier to establish a community of interest?

15. Why has legislation been ineffective in preventing the establishment of interlocking directorates?

16. What types of interlocking directorates are illegal?

CHAPTER XXIII

The Consolidated Company

Consolidation is the combining of business units that formerly were independent companies into a single corporation. The consolidated company holds and owns the assets or properties of the consolidating companies, not their stocks. The companies which are absorbed cease to exist; their charters are surrendered to the state which granted them, and their corporate organizations are discontinued. The businesses which are consolidated are often competing companies, though they may represent different stages of production of a product, or they may be merely complementary.

Consolidation may be brought about in either of two ways. First, one of the existing companies may take over the assets of the others without the formation of a new corporation, though it may be necessary to secure an amendment to its charter permitting the issue of additional stock in payment for the assets acquired. This method of combination is called *merger*. Second, all of the companies being consolidated may turn their assets over to a new corporation which is formed expressly for the purpose of effecting the consolidation. This method of combination is called *amalgamation*. The words *consolidation, merger,* and *amalgamation* are often used interchangeably, but the best usage seems to give them the distinct meanings indicated.

The method of combination which is used depends upon the circumstances of the particular case. If a number of companies of approximately equal size are to be consolidated, a new company will usually be formed to take over their assets. If a large company is being consolidated with one or two small ones, a merger may be the proper solution. Another consideration would be the charter powers of the various companies—it may be necessary for the consolidated company to exercise somewhat broader powers than any of the old companies possessed. In that case the charter of the old companies may be amended, or a new corporation may be formed. If one of the consolidating companies has valuable franchises or tax-exemption privileges, it may be easier to retain them

in that company and to arrange for it to absorb the others. Another advantage of the merger is that if the old company is continued in existence, it retains its surplus; and since dividends can usually be paid only from earnings or earned surplus, the old company can continue to pay dividends from the surplus accumulated prior to the merger. The amalgamated company begins operations without a surplus and can pay dividends only from a surplus accumulated after the consolidation has been effected. Some state laws provide, however, that the amalgamated company may retain the surpluses of the predecessor corporations. A further consideration is that amalgamation requires a new charter and the payment of incorporation fees for the new corporation, whereas a merger requires only an amendment to an existing charter and the payment of a fee for amending it and increasing the authorized capital stock.

I. History of the Consolidated Company

Consolidation is not a new form of combination, having been resorted to by corporations and joint stock companies since the days of the great trading companies. Consolidations were few in number in the United States until about the second quarter of the last century, in part because there were few joint stock companies or corporations in America during the colonial period and in part because economic conditions did not demand the building up of large business units.

Consolidation was very early an important method of combining transportation companies. Consolidation was a means of combining toll roads in the early days of highway transportation. The advantages of combining two companies which owned toll roads lying end to end, or of combining a toll road with another company which operated a bridge or a ferry constituting an essential link in the voyage of the traveler, were obvious. If the bridge was allowed to fall into disrepair or the ferry was discontinued, the business of connecting roads was seriously affected. State laws usually did not permit one company to sell its assets to another without the unanimous consent of the stockholders, but since they did permit two companies to consolidate, the logical course was either merger or amalgamation.

Many consolidations occurred during the early days of the railways. The railways were originally constructed as short lines,

many of them to supplement water transportation on canals and rivers. The difficulties attendant upon the operation of numerous end-to-end railways by different companies thus caused a gradual movement of consolidation. Many consolidations resulted after a smaller line had gone into the hands of the receiver, and in such cases consolidation was usually effected by merger rather than by amalgamation. In many cases the combination was first brought about by the acquisition of the stock, the holding company later merging the assets of its subsidiary with its own.

The consolidation movement among industrial corporations became important during the decade of the nineties. It was at this time that the weaknesses of gentlemen's agreements and pools began to be recognized. The possibilities of the holding company, moreover, were not yet fully realized. Consequently many new combinations took the form of consolidated companies. One of the large consolidations was the Diamond Match Company, which was formed in 1889. The Whisky Trust became the Distilling and Cattle Feeding Company in 1890, and the Sugar Trust became the American Sugar Refining Company in 1891. The American Tobacco Company was formed as a consolidated company in 1890.

During the period of industrial combination beginning in 1898, a number of consolidated companies were organized, most of them by amalgamation. Among the more important ones were the American Can Company (1901), the Corn Products Company (1902), and the International Harvester Company (1902). The holding company, however, was the more common method of combination during that period.

Several consolidations were effected after the Northern Securities decision in 1904. Until 1904 it was generally believed that holding companies were not subject to the prohibitions of combinations in restraint of trade embodied in the Sherman Antitrust Act of 1890, but in that year the Supreme Court ordered the dissolution of the Northern Securities Company. This was a holding company formed to take over the stocks of two great competing railroad companies, the Northern Pacific and the Great Northern. The feeling of uneasiness among other large holding companies thus caused some of them to turn to complete consolidation in the hope of getting beyond the reach of the law. The best known of these companies was the American Tobacco Company, which had become a holding company as a result of numerous acquisitions of stock after its formation in 1890. The change did not save the

combination, however, since it was ordered dissolved in 1911 as a combination in restraint of trade.

Some companies which were originally organized as holding companies have changed to consolidated companies because of economy of operation. Examples are General Motors Corporation and General Mills, Inc. Each of these companies still has a few subsidiaries but is essentially an operating company.

II. Procedure for Effecting a Consolidation

The plan for a consolidation originates with a promoter. A promoter is a person who gets the idea of the new company, formulates a plan, and undertakes to carry it into effect. Many persons promote only one company in their lifetime, while others become professional promoters and carry through the organization of several companies. In many instances, the promoter is an investment banker who not only sells the securities of corporations created by other persons but also organizes and promotes corporations on his own initiative. The investment banker has a decided advantage over the occasional and also the professional promoter because of his associations with owners of the businesses which may be consolidated and because of his contacts with the securities markets and investors. The promoter is often thought of as an unscrupulous person who seeks to sell questionable securities to unsuspecting individuals, but he is not usually that kind of person.

When the promoter undertakes to bring about a consolidation, he first makes an investigation to determine the feasibility of the idea. He studies the probable profits of the new company, the willingness of existing corporations to enter the consolidation, and the possibilities of profit to himself and to others whose assistance may be required. If the plan appears feasible, he has the assets of the companies appraised and financial statements prepared as a basis for distributing the stock of the new company.

Many plans for the allotment of the stock of the new company are possible. One plan is to exchange common stock of the new company for the assets of the predecessor companies at their appraised values. The difficulty with this plan is that it does not take into consideration the earning power contributed by each of the old companies. Some companies may be better located than others in relation to labor supply, sources of raw materials, or markets, while some companies may have an established business built upon

goodwill. The companies having large earning power could not afford to enter the combination on equal terms with less profitable companies which have plants of equal value.

To illustrate the objection to distributing common stock to the various corporations on the basis of the value of the properties, assume that Companies A, B, and C are to be amalgamated to form Company D. Assets and average earnings are as follows:

	Co. A	Co. B	Co. C
Value of properties (in excess of liabilities)	$200,000	$300,000	$500,000
Average net income, last five years........	20,000	24,000	40,000

If common stock of Company D is issued in exchange for the assets, the stockholders of Company A would receive $200,000, of Company B $300,000, and of Company C $500,000, which is a total of $1,000,000. Dividends would be paid as a percentage of common stock; and if the earnings are the same after consolidation as before, the total would be $84,000. Company D could pay dividends of 8.4 per cent. Payments to stockholders of the old companies would be as follows:

Company A...............	$16,800
Company B...............	25,200
Company C...............	42,000

Thus, Companies B and C would gain while A would lose.

A second plan would be to issue common stock in proportion to earnings contributed by each of the companies. In the case of the companies just referred to, the stock of Company D would be issued in the ratio of 20, 24, and 40, which might be as follows:

Company A...............	$200,000
Company B...............	240,000
Company C...............	400,000
Total.................	$840,000

If the income of the new company is the same as the combined income of the predecessor companies, that company could pay a dividend of ten per cent. The dividends would be precisely the same as the income earned by each company before consolidation. If Company D earned more than $84,000, the increased income would be shared by the stockholders of the old companies in proportion to the stock of the new company held, namely 20/84, 24/84, and 40/84. They might or might not consider the ratio to be equitable. Furthermore, in the event of liquidation of Company D, the

stockholders would share in the distribution of assets in the same ratio. This would be inequitable to some of the former stockholders.

In the illustration last presented, the total value of properties taken over by the new company was $1,000,000 while only $840,000 stock was issued in exchange. The difference, $160,000, would be shown in the accounts and statements as Premium on Stock. More stock could be issued for the assets without affecting the ratio of dividends so long as each group of shareholders received the same percentage of the total stock issued.

A third possible plan would be to pay for the assets of each company in bonds or preferred stock, with an amount of common stock as a bonus representing any additional earning power. The bonds or preferred stock would protect the original owners in case of the dissolution of the company, since in liquidation they would be retired first. The common stock would be issued to each company in such proportions that each would be assured dividends equal to the amount of earnings which it contributed to the consolidated company, provided the earnings were the same after consolidation as before. In practice, the stock is frequently issued in such amounts that dividends on the common stock are contingent upon an increase in earnings after consolidation.

If preferred stock is issued for properties and common stock for additional earning power, the distribution in the case of Companies A, B, and C previously referred to would be as follows:

	6% Preferred Stock	*Common Stock*	*Total*
Company A	$200,000	$100,000	$300,000
Company B	300,000	75,000	375,000
Company C	500,000	125,000	625,000
Total	$1,000,000	$300,000	$1,300,000

With the same income as that of the predecessor companies, Company D could pay the six per cent dividends on the preferred stock and eight per cent on the common. Distributions would be as follows:

On stock issued to stockholders of	*Preferred Dividend 6%*	*Common Dividend 8%*	*Total*
Company A	$12,000	$8,000	$20,000
Company B	18,000	6,000	24,000
Company C	30,000	10,000	40,000
Total	$60,000	$24,000	$84,000

This plan protects the asset equities of the former stockholders because the preferred stock would be paid first in the event of liquidation. It also assures a fair distribution of income, provided the earnings of Company D are $84,000 per year. If the income exceeds that amount, the additional dividends would be paid in the ratio of the holdings of common stock, which is 100,000, 75,000, and 125,000.

It will be observed that the total stock issued by Company D is $1,300,000. Since the properties of the predecessor companies were assumed to be worth only $1,000,000, the additional $300,000 might be reflected in an overvaluation of the properties, by setting up goodwill as an asset in that amount, or by recording discount on stock. In either case the stock is said to be watered.

A fourth possibility is to issue the same amounts of preferred and common stock in exchange for the assets as in the third plan, but to make the preferred stock participating. If the earnings of Company D are $84,000, the distribution of dividends would be the same as in the third illustration. However, if Company D should earn more than that amount, the additional dividends would be paid as a participating dividend on all of the outstanding stock. Thus, if the total income to be paid in dividends should be $110,000, Company D would first pay the preferred dividend of six per cent and then a common dividend of a stated percentage, say eight per cent. The additional amount would be a participating dividend which might be paid at the same percentage on the preferred and the common. Distribution would be two per cent on each class, as follows:

	Participating Dividend		
On stock issued to stockholders of	*On Preferred Stock 2%*	*On Common Stock 2%*	*Total*
Company A	$4,000	$2,000	$6,000
Company B	6,000	1,500	7,500
Company C	10,000	2,500	12,500
Total	$20,000	$6,000	$26,000

The fourth method is usually best because it permits all stockholders to participate in the additional income on a more equitable basis. The percentages used in the first distribution of dividends to the preferred and the common stockholders are of course only illustrative. Any percentages could be used if provided in the charter. The illustration has also been unduly simplified in that no provision was made for the issue of stock to promoters or bankers. It was

also assumed that all shareholders agreed to accept stock of Company D in exchange for stock in the predecessor companies.

The promoter next attempts to obtain the acceptance of his plans. Each company must be approached separately, and separate proposals must be made and accepted. The joint agreement must be approved by the boards of directors of the different companies. This agreement provides for the terms of the consolidation, the method of effecting it, the payment to be made to the promoter, and the basis for the exchange of shares. The plan must also be approved by a vote of the stockholders. Formerly a unanimous vote was required, but recent incorporation statutes permit a simple majority vote or a two-thirds or three-fourths vote. The reason for the reduction in the required vote is that the former rule permitted a small group of stockholders to demand exorbitant concessions before giving their permission. Copies of the consolidation agreements must be filed with the secretary of state in all states from which the corporations have received charters.[1]

The original plan may have to be modified. Not all companies will agree to come in under the original plan. The promoter then must decide whether to alter his plan or to form the consolidation with a smaller number of companies. Since the plans have not been made public, he can alter them in individual cases when he sees fit to do so. The usual result is a watering of the stock.

It may be necessary to pay for some of the properties in cash. This may be desirable if the price asked is not too high, for each owner who is paid in full often means one less person for whom a place must be made in the organization of the new company. The cash paid for properties is provided by the sale of stock to the public.

The contracts for the purchase of the properties must be taken over by the new corporation. After the promoter holds duly executed contracts for the purchase of the properties, he applies for a corporate charter in the case of an amalgamation or for an amendment to the charter of one of the companies, if necessary, in the case of a merger. The new corporation, through its board of directors, accepts the contracts made by the promoter in its name, and issues the securities in payment for the properties. The directors also vote a payment to the promoter for his services. Pay-

[1] "Statutory Merger and Consolidation of Corporations," *Yale Law Journal,* Nov., 1935, Vol. 45, pp. 105-134.

ment is usually made in stock, but it may be in cash. The consolidation is now complete.

III. Protection of Interested Groups

The persons who are interested in the consolidation and whose rights must be recognized and protected include the minority stockholders of the consolidating corporations who do not approve of the consolidation, the preferred stockholders and the bondholders of the old companies, the unsecured creditors, and possibly the majority stockholders of the old companies which agree to the consolidation.

The promoter cannot make secret profits. Legally, the promoter stands in a position of trust or confidence to the corporation he is promoting, and he must deal fairly with it. When he makes contracts with it, he cannot dominate it or its board of directors. He must observe the utmost good faith and is obliged to make a full disclosure of all facts pertaining to the property transferred to the corporation. If he places an excessive valuation upon the property through a fraudulent appraisal, he may be liable for the wrongful profits.[2] Any unfair advantage or profit made without disclosure of all the facts to the corporation is fraud, and it makes no difference whether the profit is in cash, stock, bonds, notes, or other property. In case of secret profits, the corporation may take action against the promoter for the benefit of the creditors or shareholders.[3]

Promoters have been made subject to increased supervision under the Securities Act of 1933. When securities are to be sold in interstate commerce it is necessary that a registration statement be filed with the Securities and Exchange Commission. The promoter is required to give information with respect to his past experience and particularly to indicate whether any state has denied him the right to sell stocks under the state securities laws. He must also give detailed information concerning the stock distribution contemplated, the provisions of the underwriting contract for the sale of the securities, the nature of the property to be purchased by the corporation, and a balance sheet and statement of profit and loss, if any. He must also indicate what the compensation of the officers and promoters is to be through salaries, price discounts,

[2] McCandless *v.* Furland, 52 Sup. Ct. 41 (1935).

[3] Robert S. Stevens: *Handbook on the Law of Corporations,* p. 173. West Publishing Company, St. Paul, 1936.

commissions, bonuses, or otherwise. This information becomes available not only to the directors but also to those who purchase the stock. If the answers to the questions are incomplete, untrue, or misleading, the promoter is liable.

The Commission may refuse to permit a registration statement to become effective if it contains a misstatement or if it omits something required to be stated. It may also suspend a statement if it finds that the statement is misleading, false, or incomplete. Experts in the analysis of securities and also technical appraisers who may check the valuation placed upon properties are employed by the Commission. The Commission coöperates with securities commissioners of the states, who report fraudulent promotion schemes and the names of the promoters. Thus, the Securities Act affords protection of the investor prior to the making of the investment. This is much more effective than attempted recovery after losses have been sustained.

The rights of the dissenting stockholders must be protected. The percentage of stock required for the authorization of an amalgamation or merger varies among the states. Unanimous consent is usually not required. Most states permit the consolidating corporations to prescribe the manner in which they will unite and the method of distributing the securities of the new corporation among the stockholders of the consolidating companies, provided the arrangement is fair to all of the stockholders. If a stockholder of one of the old corporations does not approve of the merger, he may have his stock appraised and he is entitled to be paid in cash. Most states specify that the dissenting stockholders must be paid the fair value or the fair cash value of their stock. Some states specify market value, though obviously the market value might be subject to manipulation. A few states provide that the dissenting stockholder shall be paid the market value of the stock but not less than the book value according to the latest balance sheet. If a stockholder believes that the transaction is illegal, he may insist that the several companies continue as independent units. An aggressive and well-financed minority has many times been able to defeat a proposed consolidation.

A minority may be able to prevent the consolidation of two or more companies when one company owns a large percentage of the stock of other corporations and proposes to merge their assets with its own. They may block the merger by court procedure, even though the company owns more than the percentage of stock re-

quired by law for authorizing the merger, and even though it offers the minority cash or stock on what appear to be favorable terms. A merger in such circumstances would amount to forcing the minority to sell their stock to a company on terms fixed by itself.[4]

The conversion rights of stock or bonds are extinguished by a consolidation. If preferred stock or bonds of a corporation carry the privilege of conversion into the common stock or other corporate security at the option of the holder, this right is lost when the corporation merges or amalgamates with another and terminates its corporate existence. It could not be expected that the corporation should continue in existence indefinitely in order to offer to exchange its common stock for bonds. In case of amalgamation the new company would assume the bonds, but it would not be obliged to offer a conversion privilege unless the original agreement with the bondholder expressly provided for such a contingency and provided a formula for determining the basis of conversion under the new conditions.

Another right of bondholders which is extinguished by the consolidation is that right which is covered by the "after-acquired" clause. This is a provision that the bond is secured by a mortgage on certain specified property which the corporation now holds, and that all property to be thereafter acquired by the corporation is covered by the same mortgage. If the corporation which issued the bonds is merged or amalgamated with another, the clause is virtually cancelled, since that corporation acquires no more property. If a number of companies have bonds containing the "after-acquired" clause, this may constitute an argument for consolidation as compared to the formation of a holding company.

Creditors of the consolidating companies have important rights. A creditor who holds a mortage on the property of one of the consolidating companies continues to hold his lien after the corporation is merged. The liabilities of all the consolidating companies are assumed by the consolidated company. If a number of companies are amalgamated to form a new company, the creditors of the weaker companies will probably find their position improved. The creditors of some companies might find their security impaired, since the stronger companies now would have to help carry the weaker ones. However, if the new company is well managed and realizes the economies of large-scale production, the position of all the creditors may be more secure.

[4] Outwater *v.* Public Service Corp. of New Jersey, 146 Atl. 916 (1929).

An interesting question arises if the consolidated company becomes bankrupt before it has paid all of the debts of the original companies that it assumed at the time of consolidation. The usual view is that the assets of the corporation constitute a trust fund for the payment of its debts and that a corporation cannot enter a merger or amalgamation if the rights of creditors are impaired. Therefore, courts of equity permit the creditors to follow the assets, and even though they do not have a mortgage lien upon them, they may appropriate them to the payment of their claims. The rights of creditors might be impaired as a result of the consolidation if the assets are dissipated by the consolidated corporation before the creditors take action.

The consolidated corporation succeeds to all the rights and obligations of the consolidating companies. The new company acacquires all of the properties of the old companies, including their franchises and patents and also their claims against other persons or companies for patent infringement or other damages. If the old companies have received the privilege of tax exemption at the time of erecting a factory in any city or state, the new company may enjoy the same exemption, but only in so far as it applies to property taken over from that company. Other property of the new company will not be exempt from taxes under the agreement.

One of the assets of the consolidating companies which passes to the consolidated company is the goodwill. The right to the goodwill is usually protected by an agreement with the owners of the old companies, which provides that they will not engage in the same business within a specified territory for a certain period of years. The agreement should take in only the territory and the time necessary to protect the purchaser in the profits of the business which it has acquired.

The consolidated company must assume the liabilities of the merged or amalgamated companies. This fact shows the necessity for careful investigation before the consolidation is effected, to determine exactly what liabilities must be assumed.

IV. The Economic and Legal Status of the Consolidated Company

That consolidation is a desirable method of combining two or more corporations is attested by the wide use made of it. Most large corporations of today are the result of two methods of com-

bination: consolidation and the purchase of stock of other companies. When one corporation acquires all of the stock of another, it may merge the assets of the second with its own by the procedure of consolidation, or it may retain the stock and operate the second company as a subsidiary corporation.

Consolidation has several advantages from a business point of view. As compared with the looser forms of combination, consolidation has the advantage of a centralized and permanent administration. If the combination of independent businesses into larger units may be justified on economic grounds, consolidation seems to be the logical method of organization. It permits the management to effect all of the savings in manufacturing, selling, general administration, research, and financing which large business units make possible. As compared with the purchase of the stock of two or more corporations, consolidation offers these advantages:

1. It makes for greater concentration of authority and more direct administration.

2. The expenses required in maintaining a number of corporations may be dispensed with. These expenses include the corporate stock taxes, the fees of directors, the expenses of stockholders' meetings, and the costs of keeping separate books and records. Some of these expenses may be duplicated by the consolidated company if it keeps separate books for the various administrative units or branches.

3. Funds may be borrowed at lower rates of interest. It can mortgage directly the entire property of the company, whereas the holding company cannot give a mortgage on the property of all of its subsidiaries. Frequently, in a holding company organization, the subsidiary issues bonds secured by its property, and the holding company issues debenture bonds without mortgage security or bonds secured by a pledge of the stock of the subsidiary companies.

Consolidation has several disadvantages from a business standpoint. As compared with the looser forms of agreement, the consolidation is more difficult to bring about. It is expensive to organize and may require the sale of securities to the public to raise the funds for purchasing the holdings of those who refuse to come in. It takes from individual owners the control over their property and gives them stock in a large corporation in whose management they may have little voice. As compared with the holding company, it has other disadvantages, chiefly as follows:

1. It cannot easily adapt itself to local conditions. Some states levy heavy taxes upon foreign corporations. It may be desirable to meet this situation by organizing subsidiary corporations in those states.

2. The names and goodwill of the separate companies which are absorbed may be lost. It is possible for the consolidated company to carry over the goodwill, however, by using the name of the former company as a branch or division of the consolidated company.

3. The consolidated company is difficult to form. Since all of the stock of the various companies to be merged or amalgamated must be acquired, the plans for consolidation must be made public if the stock is widely held. This may lead some groups to oppose the plan either because they think it is not in the interest of their company or because they think they have more to gain as an objecting minority than as adherents to the plan. The holding company, on the other hand, may quietly buy up in the market the stock of the companies it desires to control, and a majority of the stock may be considered sufficient for the purpose.

4. The consolidated company is difficult to disorganize if certain units acquired prove unprofitable. If the combination merely purchases the stock and operates the company as a subsidiary, the holding company can sell the stock. If the assets of the unprofitable unit have been merged, however, separation becomes much more difficult. An example of a company that was acquired through stock ownership and then dropped by a sale of its stock when it proved unprofitable is the Chicago and Alton Railroad. This road has been held in turn by a number of other railroad companies, each of which has voluntarily abandoned its control by selling its stock.

5. The consolidated company must assume the liabilities of the predecessor corporations. If it merely purchased the stock, its liability to loss would be limited to the amount paid for the stock.

The consolidated company is believed to have a strong position at law. It was formerly believed that, as compared to loose forms of organization such as pools or price agreements, the consolidated company was in a strong position in so far as suit under the antitrust laws is concerned. Many industries are controlled by a few large companies, in some cases by two or three companies, which are

the result of mergers, amalgamations, or acquisition of stock. These companies legally fix prices for their various constituent units, apportion markets between them, and restrict their production or increase it as conditions require. If the same companies had organized a pool to accomplish the same purposes, the combination might have been illegal. The distinction between the two forms of combination arises from the fact that the consolidated company is believed to make possible many of the economies of large-scale production which ultimately are expected to benefit the public, while the usual object of the pool is to restrict competition and to raise prices.

The view that the consolidated company has a favored position at law was denied by the Supreme Court in the Appalachian Coals case in 1933, in which it was held that if a consolidated company could be formed by independent producers, a pool formed by the same companies and for the same purpose was also legal.[5] The court said:

> There is no ground for holding defendants' plan illegal merely because they have not integrated their properties and have chosen to maintain their independent plants, seeking not to limit but rather to facilitate production. We know of no public policy, and none is suggested by the Sherman Act, that in order to comply with the law, those engaged in industry should be driven to unify their properties and businesses in order to correct abuses which may be corrected by less drastic measures.

The Supreme Court, in fact, does not recognize any difference between the loose combination and the combination by fusion, but approves combinations only when it believes the effect upon competition to be unintended, indirect, and incidental.[6]

The consolidated company does have a more secure position at law than the holding company under the Clayton Act of 1914. The law provides that the Federal Trade Commission may require a corporation to divest itself of the stock of another corporation if the effect of the ownership of stock is substantially to lessen competition. This provision has been construed by the courts to apply only to the acquisition of stock and not to the acquisition of assets. If such combinations restrain trade, they are illegal under the Sherman Antitrust Act, which prohibits combinations in restraint of

[5] Appalachian Coals, Inc. *v.* U.S., 288 U.S. 344 (1933).

[6] For discussion of this point, see Russell Hardy: "Loose and Consolidated Companies under the Antitrust Laws," *Georgetown Law Journal,* Jan., 1933, Vol. XXI, pp. 123-146.

trade in any form; but the Federal Trade Commission has jurisdiction only over combinations affected through the acquisition of stock. The Commission has for many years recommended that the acquisition of assets be declared illegal if the acquisition of stock would be illegal under the same circumstances.

Questions

1. What is the difference between consolidation, merger, and amalgamation?

2. When is a merger the better method of combination? When is amalgamation more likely to be the method?

3. At what period in our history did consolidations become significant? Why did they assume importance at that time?

4. What are the rights of stockholders who do not wish to surrender their stock in exchange for stock in a consolidated company?

5. Trace the steps followed in the formation of an amalgamated company. How is the procedure different in a merger?

6. Two companies, A and B, are to be consolidated to form Company C. The net assets of Company A are $100,000 and its net income has averaged $10,000. The net assets of Company B are $200,000 and its net income has averaged $30,000. Indicate the amount of stock that would be issued to the stockholders of Companies A and B in exchange for their stock by each of the four methods and explain which method is most equitable for all parties concerned.

7. What is a promoter? How is he usually paid for his services? Who decides how much he shall be paid?

8. Why is the promoter usually someone from outside the industry?

9. Why does the plan of the promoter sometimes have to be changed before the consolidation is completed?

10. What is an option? Why should the promoter get options before he makes the detailed investigation?

11. What is included in the detailed investigation? Why is such an investigation necessary?

12. What are secret profits? How may the requirement of disclosure of profits be met? To whom is the disclosure made?

13. How has the Securities Act of 1933 changed the responsibility of promoters?

14. What are conversion rights? How are they changed by consolidation?

15. What is the after-acquired clause? How is it affected by consolidation?

16. How are the rights of creditors of predecessor companies affected by consolidation?

17. Compare the advantages of consolidating the properties of two or more companies with the advantages of forming a new company to acquire their stock.

18. Why is the consolidated company more difficult to form than a holding company?

19. What is the reason for believing that a consolidated company is less liable to prosecution under the antitrust acts than the holding company?

CHAPTER XXIV

The Holding Company

The holding company is a company which controls the policies of one or more other corporations through the ownership of their stock. This control is usually gained through the ownership of a majority of the stock, but it may be gained also through the ownership of a minority interest. Many holding companies name the boards of directors of other companies and take an active part in their management with an interest of less than fifty per cent of their stock. Most holding companies are corporations, though some of them are business trusts or joint stock companies.

Some holding companies have no properties through which to engage in business directly, but place all of their capital in the stocks of other companies; such companies are called *pure* holding companies. Other companies are both operating companies and holding companies. Some holding companies have been formed to take over the stocks of subsidiaries, the constituent companies having existed prior to the organization of the holding company; and a holding company of this type is called a *consolidated* holding company. In other cases an operating company or a holding company may organize a subsidiary for the purpose of taking over certain branches of the business or to serve as a means of investing a part of the income of the holding company, and it is thus a *parent* holding company. Most holding companies illustrate both types. For example, the United States Steel Corporation is principally a consolidated holding company, but it has organized a number of subsidiary companies. A holding company which is controlled by another is an *intermediate* or *subholding* company.

The holding company was first employed as a means of combination by the railways. Somewhat later it became a favorite method of combining manufacturing and trading corporations. Among the public utilities, it has been used to a limited extent for about a hundred years, but it greatly increased in importance in the public-utility field during the decade of the 1920's. Since the use made

of the holding company has varied somewhat in different fields of activity, it seems best to discuss separately its use as a method of combining: (1) railway corporations, (2) industrial corporations, and (3) public-utility corporations.

I. Railway Holding Companies

The pure holding company is only occasionally used as a means of combining railway corporations, most railway holding companies being operating companies, also. Many railway companies grew into large systems by purchasing the stocks of other companies owning connecting lines of railway. In some instances the railway lines thus acquired constituted extensions of the line of the absorbing company; in others they acted as feeders to it; and in numerous others, competing lines were acquired. Some of the companies whose stocks were acquired were later merged with the holding company, while others were maintained as divisions or branches of the system.

Railway companies very early used the plan of control through stock ownership. As early as 1832, the Baltimore and Ohio Railroad Company received power from the legislature of the state of Maryland to purchase the stock of the Washington Branch Road. Through the purchase of a controlling interest in the stock of that road, the Baltimore and Ohio is believed to have become the first holding company in the United States.[1] It purchased the stocks of other small roads from time to time, but each purchase had to be authorized by an amendment to its charter through a special act of the legislature.

The Pennsylvania Railroad Company, incorporated in 1846, first began to acquire the stocks of other companies in 1853. The state legislature of Pennsylvania authorized it to buy the stocks of other railroad companies and to guarantee their bonds to an amount not to exceed 15 per cent of its own capital stock. By 1866 it controlled four roads through an ownership of stock.

The first instance of a pure holding company in the railway field is believed to have been the Pennsylvania Company, chartered by the legislature of Pennsylvania in 1870. The purpose of this corporation was to assist the Pennsylvania Railroad Company in buying up connecting and branch lines which were needed to build up

[1] J. C. Bonbright and G. C. Means: *The Holding Company*, p. 58, McGraw-Hill Book Co., New York, 1932.

the Pennsylvania System. All of its stock was and still is owned by the Pennsylvania Railroad Company. At the present time the Pennsylvania Railroad Company either directly or through its subsidiary holding companies controls through stock ownership or lease more than 100 other corporations engaged in transportation. It controls numerous corporations engaged in other activities, such as trucking, mining, real estate, bus, express, water supply, bridge, terminal, ferry, warehouse, electric-railway, and stock-yards companies. All of the large railway companies make extensive use of the holding-company device.

The principal use of the railway holding company has been to round out a system. Many of the subsidiary corporations operate branch lines that act as feeders to the main line or as connecting lines giving access to important industrial centers where much traffic originates. In some cases, railways of this kind are owned and controlled by two or more companies. This is true, for example, of the Chicago, Burlington, and Quincy, which is owned jointly by two roads, and the Richmond, Fredericksburg, and Potomac, which is controlled by six roads. Terminal and other facilities are often separately incorporated and jointly owned. Many of the subsidiaries of railway companies operate water systems, development projects, express service, bus lines, and other related projects. Separate corporations are maintained in some cases because state laws require it, and in other cases because the parent company has been unable to purchase all of the outstanding stock.

There has been little criticism of railway holding companies. The explanation for the lack of criticism of the use of the holding-company device by the railways is to be found in the following facts:

1. Most of the railway holding companies are also operating companies. Pure railway holding companies are uncommon.

2. The railway holding company usually owns all or almost all of the stock of its subsidiaries. Where it owns less than 100 per cent, the usual reasons are, first, that the state law requires that a corporation have three directors and that each director own at least one share of stock; and second, that small amounts of stock are owned by private interests who will not sell except at unreasonably high prices. In such cases, the holding company may gradually increase its holdings by purchases from time to time as the stock is offered on the market.

3. Railway companies make very limited use of preferred stocks and all of them strive to keep a satisfactory ratio of common stocks to bonds. The excessive bond issues of some systems are due to the mistakes of an earlier generation of promoters and the existence of a ready market for bonds through sales to savings banks, insurance companies, and other institutions.

4. The holding company device is useful if not necessary in railroad organization because many switching, terminal, and other facilities are jointly owned. The laws of some states also require that properties within the state be separately incorporated and that certain activities such as water supply and tourist service be carried on only through separate corporations.

5. There has in recent years been a complete absence of such bad financial practices as stock watering, stock warrants, misleading financial statements, control through business trusts, and nonvoting securities. Much of the credit for proper financing methods is due to the control exercised by the Interstate Commerce Commission.

Recent railway holding companies have given rise to new problems. Most of the early railway holding companies were also operating companies. Holding companies formed in more recent periods, like the Pennroad Corporation and the Allegheny Corporation, are pure holding companies, and their stock is not owned by a railway company.

The Allegheny Corporation was incorporated under the laws of Maryland in 1929 by the Van Sweringen brothers of Cleveland to acquire the shares of various companies in which they had become interested. A controlling interest in its stock was held by the Mid-America Corporation, another holding company. The Allegheny Corporation had no power to operate railroad properties. It immediately acquired large blocks of stock in the Chesapeake Corporation, a subsidiary railway holding company, and in the Chesapeake and Ohio Railway Company and the New York, Chicago, and St. Louis Railroad Company. In 1930 it purchased over 50 per cent of the stock of the Missouri Pacific Railway Company besides substantial interests in several other roads. In 1931 it acquired the stock of Terminal Shares, Inc., a newly formed holding company, which in turn purchased terminal sites and industrial properties adjacent to the Missouri Pacific lines. In 1934, the Allegheny Corporation was unable to pay the interest on its bonds, and it

offered the bondholders a plan of reorganization whereby they would receive preferred shares of the company for the coupons on the bonds maturing from 1934 to 1939. This plan was later made compulsory by the courts in accordance with the provisions of the Bankruptcy Act. The Van Sweringen brothers lost control of the company in 1935 and both died about the same time, one in 1935 and the other in 1936. They left an unstable pyramid of corporations whose solvency was threatened at every stage because of the bonded debt and the pledging of the assets of the various corporations as security. In 1942 the Chesapeake Corporation was dissolved. Its debts were paid, and the remaining assets were distributed as liquidating dividends. The Allegheny Corporation has been compelled to dispose of many of its securities to meet its liabilities though it still controls the Chesapeake and Ohio Railway Company.

When holding companies of this type were first organized, they were not subject to the jurisdiction of the Interstate Commerce Commission, since the jurisdiction of the Commission was limited to the carriers themselves. Federal control was extended to railway holding companies by the Emergency Railroad Transportation Act of 1933, which authorized the Interstate Commerce Commission to investigate whether the holding of stock of any railroad company has the effect of subjecting the road to the control of another corporation. If the holding hinders the plan of the Commission for the grouping and consolidation of railroads, the Commission may restrict the voting power of the stock and by other appropriate means prevent the holding from defeating the consolidation plan. An amendment in 1940 requires the consent of the Interstate Commerce Commission to the acquisition of control of two or more carriers by a holding company.

II. Industrial Holding Companies

The holding company as a device for combining manufacturing and trading corporations was later in development than the railway holding company. In New York the first grant of authority to an industrial corporation to own stock in another was embodied in a law passed in 1853, which permitted manufacturing corporations to purchase stock in mining companies under certain conditions. This principle was extended in 1866 and again in 1876. Yet even with these special provisions, New York did not permit a manufacturing

company to buy stock in a competing company. It was not until 1892 that this authority was embodied in the general incorporating act.[2]

The first pure industrial holding company in the United States is believed to have been the Continental Improvement Company, which was chartered by special act of the Pennsylvania legislature in 1868.[3] Another early industrial holding company, though not a pure holding company, was the Laurel Run Improvement Company. It had power to mine coal and also to buy stocks of other companies. Its stock, in turn, was owned by the Philadelphia and Reading Railway Company and was used by that company for entrance into the coal business indirectly.

The general use of the holding company device in the industrial field dates from 1889. In that year the state of New Jersey amended its general incorporation law by inserting a provision that one corporation might have the power to purchase, hold, sell, and transfer the stocks, bonds, or other obligations of another corporation. This change received little comment at the time, since most of the large combinations were organized as trusts. Within two years, however, various states had started prosecution against the trusts, and many states had enacted legislation directed at combinations in restraint of trade but particularly against the trustee device. New Jersey thus offered a substitute device which the large combinations could easily adopt. Many other states soon amended their laws to permit manufacturing and other industrial companies to own stocks in other corporations.

The holding company became a favorite device during the combination movement of 1898–1901. Since only a few industrial combinations were formed during the early 1890's, the holding company did not at once become a general form of business organization. One of the earliest large holding companies was the American Cotton Oil Company, formed in 1889 when the cottonseed-oil trust changed to a holding company. Among the well-known holding companies organized from 1898 to 1901 were the American Agricultural Chemical Company (1899), the American Locomotive Company (1901), the Eastman Kodak Company (1901), and the United States Steel Corporation (1901).

When the great holding companies were being formed at the close

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[2] United States Commissioner of Corporations: *Trust Laws and Unfair Competition,* p. 9.

[3] Bonbright and Means: *Op. cit.,* p. 61.

of the last century, it was generally believed that a combination organized as a holding company was safe from prosecution under the Federal antitrust act. The reason for the belief was that the acquisition of stock by the holding company was not interstate commerce, and the belief itself accounts in part for the large number of holding companies. But the decision of the Supreme Court in 1904 dissolving the Northern Securities Company, a railway holding company, threw doubt upon the legal position of all holding companies and caused some of them to change to consolidated companies. Later decisions, particularly in the International Harvester, the United States Steel Corporation, and the Appalachian Coals cases indicate that the courts place less emphasis upon the form of organization and greater emphasis upon the effect on competitive conditions in the industry. Consequently the holding company has come back into favor. Since 1935 the tendency has been to simplify holding company systems by the elimination of intermediate holding companies, by the merger of one subsidiary with another, and by change to the consolidated company. The principal reason for simplification of corporate structure has been tax reduction.

The United States Steel Corporation is a pure holding company. The United States Steel Corporation was formed in 1901 as a result of the combination of eleven large steel companies which were themselves the result of a series of combinations. Companies in various branches of the steel industry, such as tin-plate manufacturers, bridge companies, and manufacturers of iron tube and pipe, had combined during the years 1898 to 1900 to form large corporations in their respective fields. The companies whose stocks were acquired by the United States Steel Corporation controlled the production of steel from the mine to the finished product. Other companies have been acquired since that time, and still others have been organized to operate additional facilities constructed by the corporation.

In recent years several of the subsidiaries of the United States Steel Corporation have been merged and some of the intermediate holding companies have been eliminated. In 1945 the Corporation still had more than 130 subsidiaries of which eleven were railway companies. Its subsidiaries are engaged in all branches of the iron and steel industry including mining, transportation, steel manufacture, and shipbuilding.

The Bethlehem Steel Corporation, which is the principal competitor of the United States Steel Corporation, is about one-third its size. Bethlehem Steel Corporation is also principally a holding company, although its holds title to a number of properties which are operated by subsidiaries. Its corporate structure has been greatly simplified in recent years by the merging and consolidation of the properties of many of its operating companies. In 1945 it had about fifty subsidiaries, of which twelve were owned by intermediate holding companies.

The Standard Oil Company of New Jersey is now a pure holding company. The first Standard Oil Company was an Ohio corporation, incorporated in 1870. In 1882 when the Standard Oil Trust was reorganized, a New Jersey charter was obtained for a new Standard Oil Company to which were transferred important oil properties. The Standard Oil Company of New Jersey secured an amendment to its charter in 1899 to give it broad powers as a holding company. At the same time its authorized capital stock was increased from $10,000,000 to $110,000,000. The company then took over the stocks of the various oil companies by issuing its own stock in exchange. In 1911 it was held to be a combination in restraint of trade and was required to divest itself of the stocks of its various subsidiary companies. In 1927 it discontinued direct operations and became a pure holding company.

At the present time the Standard Oil Company of New Jersey has about 300 subsidiaries, of which more than 200 are organized under the laws of foreign countries. In most of these companies the holding company owns 100 per cent of the stock, though in a few cases it does not own quite all. Crude petroleum is produced by subsidiaries in the United States, Canada, Trinidad, Venezuela, Colombia, Peru, and Argentina, and petroleum refining operations are carried on in several foreign countries. It sells crude petroleum and its products, including gasoline, kerosene, fuel oil, heating oils, gas oils, and lubricating oils. It has a large ocean-going fleet under the American flag with much additional marine equipment flying the flags of various other countries. The company produces and distributes natural gas. It also manufactures and sells gasoline and oil storage and dispensing equipment, oil burners, oil stoves, candles, insecticides, and various allied specialties. Its subsidiaries selling gasoline also sell tires, batteries, and other automotive accessories. During the Second World War, the facilities of the subsidi-

ary companies were devoted in large part to the production of aviation gasoline, synthetic rubber, toluol for explosives, and other supplies essential for the war.

General Mills, Inc., was organized in 1928 as a pure holding company to take over the stocks of companies manufacturing flour, feed, breakfast foods, and other cereal products. In 1937 most of the subsidiaries were dissolved and the company became a consolidated company. The Texas Company, owning extensive interests in the oil industry, also was formerly a pure holding company but now is both an operating company and a holding company.

The holding company has been used to combine competing corporations. In many instances the desire to eliminate or reduce competition has been an important reason leading to the formation of a holding company. A number of holding companies have been held to be combinations in restraint of trade. In the case of the formation of the United States Steel Corporation, an important motive was a desire to prevent an increase in competition which appeared imminent.

As a device for combining competing companies, the holding company offers the same advantages as the old trust or trustee device offered, without the disadvantage of illegality. The two devices are similar in many respects. In the trust, the shares of the underlying companies were exchanged for trust certificates; in the holding company, they are exchanged for the shares of the holding company. The trust was managed by a board of trustees; the holding company is managed by a board of directors. The trust relationship was prescribed by a declaration of trust; the holding-company organization is prescribed by the corporate charter and the by-laws.

While in outward structure and organization the holding company is similar to the trust, the two devices are very different at law. The trust is a partnership of corporations, and the holding company is a corporation whose powers are granted by authority of the state. It was therefore possible for the old combinations to take holding-company charters and to do as corporations precisely the things which the common law held that they could not do as trusts. This situation has been clarified by legislation that declares any combination in restraint of trade to be illegal, regardless of the device or method of organization.

The holding company has been used to avoid difficulties in financing. The principal advantage is in the evasion of "after-ac-

quired" clauses in mortgages. If a company has issued a mortgage on its property with the provision that any property later acquired will be covered by the same mortgage, the effect may be avoided by arranging that all property subsequently acquired shall be held in the name of some other company. Another subsidiary might be organized for the purpose of owning and managing the property.

The holding company is relatively easy to form. Once it is decided by financiers or promoters that a combination of certain corporations would be desirable or profitable, it may be found that the holding-company arrangement is simpler and meets with less objection from the stockholders of the underlying companies than would amalgamation or merger. All that is required is that the stocks of the various companies be purchased, and it is not necessary to acquire all of the stock at one time. A controlling interest may be owned before the small stockholders know what is taking place. In a period of rapid growth of holding companies, however, the large companies frequently bid against each other for the stock in the market until the stocks are run up to very high prices.

The holding company offers certain advantages in the administration of large properties. Among the operating advantages are the following:

1. Domestic corporations may be organized in each state where local conditions make them desirable. In states which place heavy taxes upon foreign corporations, a domestic corporation may be organized to own the properties and conduct the business in that state.

2. Administration may be decentralized. This advantage may be obtained by a consolidated company, however, by the organizing of separate properties as administrative units. It is sometimes argued that the holding company makes possible the comparison of the profits of the different factories or branches of the business through income statements for each company. This advantage may be accomplished just as easily by the consolidated company through a proper organization of its accounting system.

3. The company may produce cheap or low-priced goods through some of its subsidiaries without endangering the goodwill of the other companies. This is probably a real advantage, though by proper advertising and by the organization of divisions, the consolidated company may accomplish the same purpose. A similar practice is the sale through one subsidiary of a product of better

quality than the products of other subsidiaries or of the holding company. For example, the fact that Sears Roebuck and Company owned the *Encyclopedia Britannica* was kept secret until the company gave the publication rights to the University of Chicago.

4. The holding-company device may be used to reduce the risk involved in undertaking experimental projects from which a company later might wish to withdraw. If the new business or side line is separately incorporated, the holding company may withdraw merely by selling the stock, whereas if it were undertaken directly, it would be required to dispose of the assets. If a new article is marketed by a subsidiary, its failure to appeal to the public does not reflect upon the goodwill of the parent company or the other subsidiaries so much as it would have done if the product had been put upon the market by the parent company itself.

5. The holding-company device may be used to conceal the fact that certain subsidiaries are parts of a larger combination. When public opinion has been adverse to large combinations loosely designated as "trusts," the holding companies have continued to operate newly acquired companies as though they were independents, in order to avoid the ill will associated with the name of the holding company.

The holding company has some disadvantages in administration. These are as follows:

1. The maintenance of a great many corporate structures is expensive. The outlays for franchise taxes, the expenses of separate boards of directors, the salaries and expenses of officers for the various companies, and the expenses of stockholders' meetings, may involve a greater cost than the structure is worth.

2. The goodwill of the organization may be lost among so many companies. The goodwill of one subsidiary will not easily be carried over to another, and whatever goodwill the holding company has may fail to benefit its numerous subsidiaries as it would if the organization were consolidated.

III. Public-Utility Holding Companies

Public-utility holding companies were organized as early as the decade of 1880 to 1890 with the formation of a number of companies owning the stocks of telegraph, telephone, gas, and a few other

types of public-utility corporations. One of the earliest holding companies in this field was the Western Union Telegraph Company, which had acquired control of most of the telegraph companies in the United States by 1881.[4] The first pure public-utility holding company was the American Bell Telephone Company, which was chartered by the state of Massachusetts in 1880. The great public-utility corporations are for the most part the result of decades of growth, though the increase in their size was especially rapid during the years 1920 to 1929.

The American Telephone and Telegraph Company is both a holding company and an operating company. This company controls almost all of the telephone business of the United States through its long-distance lines, which are directly owned, and through its subsidiary corporations, which operate in various sections of the United States. There are 21 operating companies constituting the Bell System. The American Telephone and Telegraph Company owns 98 per cent of the stock of Western Electric Company, which manufactures telephone equipment for the entire organization. The Western Electric Company also manufactures various types of electrical equipment that is for other than telephone service and is sold directly to outsiders. The American Telephone and Telegraph Company is a minority stockholder in the Bell Telephone Company of Canada and owns fifty per cent of the stock of the Cuban-American Telephone and Telegraph Company. Most of the subsidiary corporations are both operating companies and holding companies. The New York Telephone Company controls twenty subsidiaries, while the Southwestern Bell Telephone Company controls 31 companies. The majority of the subsidiaries are local telephone companies, but the New York Telephone Company controls several electric protective, burglar-alarm, and fire-alarm companies.

The American Telephone and Telegraph Company has brought all of its subsidiaries into a unified system, this unification having been accomplished through contracts whereby it provides various services for its subsidiary and affiliated companies. These services, for which a charge is made by the holding company, include the providing of telephone service between the regional operating companies through its long-distance lines, temporary financing, aid in permanent financing, the development of telephone operating meth-

[4] W. M. W. Splawn: *Hearings before Committee on Interstate and Foreign Commerce of the House of Representatives,* March, 1932, p. 6.

ods, and the protection of telephone patents. These services have enabled the parent company to develop a uniform policy for all of the companies of the Bell System.

Cities Service Company is both a public-utility and an industrial holding company. Cities Service Company controls public-utility corporations which supply electric light and power, natural and artificial gas, steam heating, water, bus service, and street-car service in various communities in Arizona, New Mexico, Tennessee, and a few other states. At the same time it controls more than fifty companies in the oil industry. These companies in the aggregate represent a complete system of the production, transportation, refining, and marketing of oil and its by-products. The company also owns ten realty companies and three mutual service companies which perform essential services for the utility corporations.

The operating properties of the Cities Service Company are grouped under three subholding companies. The Cities Service Power and Light Company owns the public utilities other than gas, while the Empire Gas and Fuel Company controls the petroleum and gas properties. The Arkansas Natural Gas Corporation owns the stocks of companies engaged in the production, transportation, refining, and marketing of petroleum and the production and distribution of natural gas. In recent years the Cities Service Company has attempted to simplify its financial structure. At the beginning of 1934, the company had a total of 189 subsidiaries, but by the beginning of 1945 the number had been reduced to 120. This policy has also been followed by several other large holding companies.

Some holding-company systems are centralized. An example of a centralized system is that of the Electric Bond and Share Company. This company was formed in 1905 by the General Electric Company to promote public-utility enterprises and to create a demand for electric equipment. The General Electric Company disposed of its stock in the company in 1914. The operating companies in the Electric Bond and Share system are controlled through five large intermediate holding companies. One of these, the American and Foreign Power Company, had more than one hundred subsidiaries in 1945. The Electric Bond and Share Company owns less than fifty per cent of the stock of the intermediate holding companies, the smallest percentage in 1945 being 17.6 per cent of the American Gas and Electric Company.

Most of the companies in the Electric Bond and Share system

serve small cities or towns, and the companies are not large enough to provide many services for themselves. The holding company has therefore organized service companies to do their purchasing, engineering, construction, accounting and auditing, advertising, public relations, tax, and legal work. The holding company itself aids the subsidiaries in their financing. The income from such services constitutes a substantial part of the income of the holding company.

Some holding-company systems are decentralized. An example of a decentralized system is that of the North American Company. This company was organized in New Jersey in 1890 to take over the holdings of a predecessor company. It began as a holding company for steam railroads but later transferred its interests to public-utility corporations. The companies which it now controls render electric light, power, gas, street railway, bus, and other services to cities in a wide range of territory. Its operating units serve principally large cities, such as Washington, D.C., St. Louis, and Cleveland, although since 1920 it has extended its control to a few properties in smaller cities.

Most of the units of the North American Company system are large, and each is able to provide its own staff of engineers, accountants, and other technical experts. The holding company furnishes no supervision, engineering, accounting, or construction services for which fees are charged. It does, however, regularly receive financial and operating reports from its subsidiaries; these are compared one with another and the officers of the holding company advise with the officers of the subsidiary corporations. Joint committees of operating men meet at regular intervals to discuss their problems and to exchange ideas. The officers of the holding company also occasionally visit the properties of the subsidiaries in a general advisory capacity. The holding company maintains the stock-transfer records of the subsidiary corporations and performs some other financial services for them. For these services it receives the usual fees charged by banks and trust companies; these charges in the aggregate, however, are a relatively small part of its income.

Public-utility holding companies may be able to achieve many operating economies. Public-utility holding companies, it is contended, are able to render at low cost expert management services to the subsidiary companies, as in engineering and construction services, legal assistance, accounting, purchasing, and financing.

The holding company may make additional economies possible through the construction of interconnecting transmission lines between the properties of the various subsidiaries. The interconnecting lines enable the subsidiaries to take some of their facilities out of service for repairs without interrupting service to customers. The water power of the different generating plants may be more effectively utilized by interconnections; and the peak loads of some systems may be carried by others whose peak loads occur at different hours of the day or on different days of the week. If two parts of the holding-company system find it necessary to add to their generating capacity, one of them may carry out the expansion and supply the needs of the other from a part of the additional capacity, which would not otherwise be employed. Pooling the facilities also reduces the amount of reserve equipment required to take care of breakdowns.

The holding company has been used to limit liability. In risky enterprises, such as the operation of electrical plants, there is always the possibility of heavy losses through the breaking of a dam and the flooding of a large section of the country. Somewhat different risks are involved in the operation of street-railway systems which have had to meet the competition of new forms of transportation. But a holding company may reduce its liability and strengthen its credit by keeping each of its properties in the name and ownership of a separate subsidiary. The liability of the holding company as a stockholder is limited just as the liability of any individual stockholder is limited. The device of incorporating each unit of the business as a separate corporation thus offers an advantage to the company much the same as it offers to the individual who prefers not to become a member of a great many partnerships.

The holding company has been used to concentrate control with a small investment. The method of controlling a large amount of property with a small investment is seen particularly in the public-utility industry. Concentration of control arises from the fact that with a series of subsidiaries and holding companies one above the other and each selling a part of its securities to the public, the percentage of the stock of the top holding company necessary to control the whole system is a relatively small percentage of the total of all issues. A majority interest in the stock of the top holding company assures the control not only of the holding company but also of all of its subsidiaries. This practice is commonly spoken of as *pyramiding;* it is also called *trading on the equity.*

To make the situation as concrete as possible, let it be assumed that Company A, an operating company, finances a property worth $100,000,000 by an issue of securities, 40 per cent of which is in bonds, 20 per cent in preferred stock, and 40 per cent in common stock. This would mean an issue of $40,000,000 in common stock, which would be the only security having voting rights. The balance sheet of Company A would be as follows:

COMPANY A, OPERATING COMPANY

Assets		*Liabilities and Capital*	
Plant and Equipment	$100,000,000	Bonds Payable	$40,000,000
		Preferred Stock	20,000,000
		Common Stock	40,000,000
Total	$100,000,000	Total	$100,000,000

Company B, a holding company, is organized. It acquires all of the common stock of Company A from the stockholders of that company, paying for the stock with its own stock and bonds, which are issued in exchange or with cash derived from the sale of its securities. Company B then makes an issue 40 per cent in collateral trust bonds, secured by a deposit of the securities being acquired; 20 per cent in preferred stock, 20 per cent in non-voting common stock, and 20 per cent in voting common stock. The voting stock is purchased by the promoters at par of $100 per share. The balance sheet of Company B would be as follows:

COMPANY B, HOLDING COMPANY

Assets		*Liabilities and Net Worth*	
Stock of Company A	$40,000,000	Bonds Payable	$16,000,000
		Preferred Stock	8,000,000
		Non-Voting Common Stock	8,000,000
		Voting Common Stock	8,000,000
Total	$40,000,000	Total	$40,000,000

The control of the operating company with property of $100,000,000 is assured by an investment of $8,000,000. The controlling interest may sell $4,000,000 of the stock (thus reducing their investment to $4,000,000) and still keep control. And if they form a third company, C, to take over the stock of Company B, they may reduce still further the amount of cash required.

In the illustration cited, it has been assumed that the stock of holding Companies B and C has not been watered. If the pro-

moters issue stocks to themselves for their services in forming the holding company, their cash investment may be reduced to the vanishing point.[5]

Many other devices are employed to assure control of subsidiaries with a small investment. Besides the use of non-voting stock and the pyramiding of companies, public-utility promoters and managers have used such devices as low-priced management shares with concentrated voting power, the authorization of large blocks of unissued voting stock held in reserve to be issued when the management needs more voting power, contracts with officers and others to supply the holding company with proxies, and voting trust agreements naming the directors of the holding company as trustees to vote the stock. Option warrants have been issued giving the holders the right to buy more shares at any future time at a specified price. The issuance of bonds and preferred stock which were convertible into common stock was another device to give some groups a favored position. Some subsidiaries were organized as business trusts with shares that legally could carry no voting rights. The officers of the holding company were named as trustees with full powers of management. Elimination of the preëmptive right gave the directors the power to issue more shares to themselves or to the holding company, if necessary to assure a continuance of control. Another plan was to elect the directors for a term of years with only a minority reëlected each year. If some of the directors should fail of reëlection through a surprise move by a group of shareholders, the holding company could retrieve the situation by the issue of more stock to itself or in some other manner before the next meeting of the stockholders. Thus, by one or more devices, the holding company managed to establish and to retain control of its subsidiaries through a relatively small investment.

The holding company is used to increase the rate of earnings on the investment. To illustrate how the pyramiding of companies may bring increased profits, let us refer to the hypothetical illustration of Companies A and B just given. If opertaing Company A earns 8 per cent on its investment in plant and equipment, it will have an income of $8,000,000. Interest on its $40,000,000 in bonds at 5 per cent would require $2,000,000 of this, and dividends of

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[5] In the railway field, control of the Allegheny Corporation and its railroads valued at $2,000,000,000 was acquired in 1935 by Robert R. Young at a cost reported to have been $254,295. See Matthew Josephson: "The Daring Young Man of Wall Street," *The Saturday Evening Post,* August 11, 1945, Vol. 218, No. 6, p. 12.

6 per cent on the preferred stock would take $1,200,000. This would leave $4,800,000 for the common stock, which would be 12 per cent on the par value. Now if this were paid to Company B as dividends, that company would pay $800,000 as interest on its bonds at 5 per cent, $480,000 as dividends on its preferred stock at 6 per cent, and the balance, amounting to $3,520,000, would be available for dividends on its common stock—this sum amounting to 22 per cent of par. Thus, the more the holding companies are added one above the other, the greater is the possibility of profit to the holders of the stock of the top company.

The danger in the pyramiding of holding companies is that it increases the risk of loss in proportion to the increase in the possibilities for profit. If Company A in the previous illustration earns only 4 per cent on its investment, the entire income would be required to pay the interest on the bonds and the dividends on preferred stock of Company A and the interest on bonds of Company B, leaving nothing for the preferred or common stocks of Company B. If the income should fall to 3 per cent, Company B would default on its bond interest unless it had a surplus upon which it could draw, and the whole pyramided structure would fall. The income statements of the operating company and the holding company would be as follows:

OPERATING COMPANY
INCOME STATEMENT

	Income of 8%	*Income of 4%*
Income before Interest	$8,000,000	$4,000,000
Interest on Bonds 5%	2,000,000	2,000,000
Balance for Stockholders	$6,000,000	$2,000,000
Dividend on Preferred Stock 6%	1,200,000	1,200,000
Available for Common Dividends (12%)	$4,800,000	(2%) $800,000

HOLDING COMPANY
INCOME STATEMENT

	Income of 8%	*Income of 4%*
Income before Interest	$4,800,000	$800,000
Interest on Bonds 5%	800,000	800,000
Balance for Stockholders	$4,000,000	None
Dividend on Preferred Stock 6%	480,000	None
Available for Common Dividends (22%)	$3,520,000	None

It has been argued that a holding-company structure with a large issue of bonds and preferred stocks and a small issue of common stocks is safe in the public-utility field because earnings are relatively stable, whereas it might involve too great hazards in the more speculative branches of industry. However, it has been shown that even the earnings of electrical, telephone, gas, and other public utilities are dependent upon industrial prosperity, although not to the same extent as earnings in other industries. The holders of collateral trust bonds and preferred stocks of the pyramided companies are, in fact, asked to assume risks comparable to those assumed by common stockholders, without the possibilities of large earnings which are usually associated with such risks. Moreover, the pyramiding carries with it serious possibilities for the underlying companies, whose financial position may be seriously disturbed by the failure of the system.

The subsidiary corporations may be mismanaged in the interests of persons controlling them. Many opportunities for mismanagement of subsidiary corporations arise through financial arrangements between the various companies. Three types of such mismanagement, called "milking the subsidiary," may be distinguished.

1. The subsidiary may be mismanaged for the benefit of the holding company. This may be accomplished by requiring the subsidiary to pay dividends when the funds thus distributed are needed by the subsidiary to provide additional facilities. Income of the subsidiary may be overstated through the omission of depreciation charges or failure to keep properties in good condition. The holding company may profit at the expense of the operating company by making excessive charges for legal and other services.

2. One subsidiary may be mismanaged in the interests of another. One method of accomplishing this purpose is for one subsidiary to render services to others for which high charges are made. Such services include the purchase of gas, coal, and other supplies, the construction of equipment or buildings, the management of advertising programs, and the rendering of tax and legal services. An indirect method of milking one subsidiary in the interest of another is to neglect the business of one company and to expand the business of another. For example, a holding company which controls a gas company and an electric company in the same

city may fail to promote the use of gas while encouraging the use of electrical appliances such as refrigerators and stoves.

3. The subsidiary may be mismanaged in the interests of the officers of the holding company or in the interests of companies owned by them. This is done through contracts to the disadvantage of the operating company.

A combination of the three methods is usually employed. A specific example is afforded by a gas company on the Atlantic seaboard. A holding company acquired a controlling interest in this public utility through a business trust which it controlled. The holding company then required the gas company to make a management contract with another subsidiary at $12,000 per year. This contract, however, was withdrawn upon demand of the utilities commission. The holding company required the gas company to transfer to another subsidiary the contract for the transmission of gas to its local pipe lines. In addition, the holding company charged a fee of $2,400 per month for the purchase of gas, though in fact it rendered no services. It placed some of its employees on the payroll of the gas company at exorbitant salaries, in some cases as high as $100 per day; it paid part of the salary to the employee and took the balance for itself. These contracts were cancelled by order of the utilities commission. While this was perhaps an exceptional case, there is always the possibility of financial mismanagement where the holding company owns less than 100 per cent of the stock.

Many other abuses have been attributed to the public-utility holding company. The following are some of the practices of the holding company which have been criticized:

1. Loading the fixed capital account of operating utilities with arbitrary amounts in order to establish a base for excessive rates.

2. Engaging in transactions for the purchase or sale of property or securities with controlled or subsidiary companies for the purpose of recording arbitrary profits or fixing valuations unjustified by market values.

3. Disregard of prudent financing in excessive issues of bonds, imperiling the solvency of the subsidiary and involving excessive charges for interest and commissions.

4. Deceptive methods of dividing earnings as between operating companies and the parent company.

5. Inter-company financing on a basis disadvantageous to the operating company.

6. Payment of unearned or unwarranted dividends by the subsidiary.

The states have partially dealt with the holding-company problem. State control of public-utility corporations has become increasingly effective since 1930, but not all states have enacted legislation designed to correct the abuses of holding companies. In fact most states still rely for possible control upon the regulation of the local operating company. The most advanced legislation has been along these lines:

1. In a number of states, the public-utility regulating commissions have been given power to regulate service contracts and other arrangements between the operating company and the holding company. The principal difficulties involved in the enforcement of such legislation are the legal barriers resulting from the fact that the holding company maintains its office in another state and the expense to the local commission in undertaking to investigate the holding company.

2. "Upstream loans," or loans from the subsidiary to the parent company, are prohibited in many states.

3. Depreciation allowances have been made mandatory and placed under the supervision of the utilities commission.

4. Some states now prohibit the purchase or other acquisition of the voting stock of a public-utility corporation by another public utility. Holding companies desiring to purchase the stock of a public utility must obtain the consent of the utilities commission.

The courts have also removed some of the legal barriers to effective state control of the public-utility holding company. In a leading case, it was held that a regulatory commission may disapprove unreasonable expenditures by a public utility and it may regulate the charges made against a local public utility by an out-of-state company where the two companies are commonly owned and the out-of-state company is, in effect, serving the local consumer. Thus, the Public Service Commission of Kansas was upheld in issuing an order that local gas companies cease setting up as an item of operating expense more than a certain amount for gas furnished them by an interstate pipe-line company.[6]

[6] State Corporation Commission *v.* Wichita Gas Co., 54 Sup. Ct. 321 (1934).

Public-utility holding companies are now subject to Federal regulation. The Public Utility Act of 1935 declares that the Federal government has the power to regulate holding companies because: (1) their securities are sold in interstate commerce; (2) their service and other contracts are made through the mails and other instrumentalities of interstate commerce; (3) their subsidiaries sell and transport gas and electricity in interstate commerce; and (4) their activities extending over many states are not susceptible to effective control and regulation by the states. The Act requires that public-utility holding companies register with the Securities and Exchange Commission and furnish in the registration statement information similar to that required by the Securities Exchange Act of 1934.

The Securities and Exchange Commission is given control over a wide range of activities of public-utility holding companies. Its consent is required when holding companies desire to purchase the securities or assets of operating utilities unless the consent of a state commission has been obtained or the businesses of both the holding company and the operating company are organized in one state and are confined exclusively to that state. The Commission may refuse its consent if it finds that the acquisition will tend toward a concentration of control that would be detrimental to the public interest, that the amount to be paid is unreasonable or unfair, or that the acquisition will unduly complicate the capital structure of the holding company.

Securities cannot be issued by holding companies without the approval of the Commission. No par stock is not permitted. All stock must have voting rights. Preferred stock cannot be issued, and bonds must be secured by physical assets or by first mortgage bonds of subsidiaries. The effect of these provisions is to prevent the building up of holding-company systems through the issuance of debenture bonds, collateral trust bonds, and preferred stock. The rules of the Commission require that no securities be issued to banks or others without competitive bidding. Formerly it was the practice to sell securities to a bank for whatever it offered with no shopping around in the market.

The Commission is authorized to establish regulations concerning inter-company loans and the payment of dividends. Under the rules, upstream loans are prohibited. Dividends can be paid only from earnings and not from capital surplus. The Commission regulates the purchase and sale of utility- and holding-company securi-

ties and assets, and the solicitation of proxies of operating companies and the holding company. It may also establish regulations governing construction work by one company in a holding-company system for another, service contracts, and purchases and sales of gas and electric power. Such rules and regulations as the Commission may prescribe shall be designed to insure that the contracts are performed economically and efficiently for the benefit of the associated companies. The Commission may refuse to permit one company to continue to perform mutual services for others unless it finds that the company is organized to render efficient service. It is also authorized to order a reapportionment of costs among member companies served by such a company if it finds that the existing allocation is inequitable. To enable the Commission to enforce these provisions, the holding companies and their subsidiaries are required to render periodical reports and the Commission is further authorized to make additional investigations of service and other contracts. The results of all investigations are to be made available to state regulating commissions as well as to the public and to Congress.

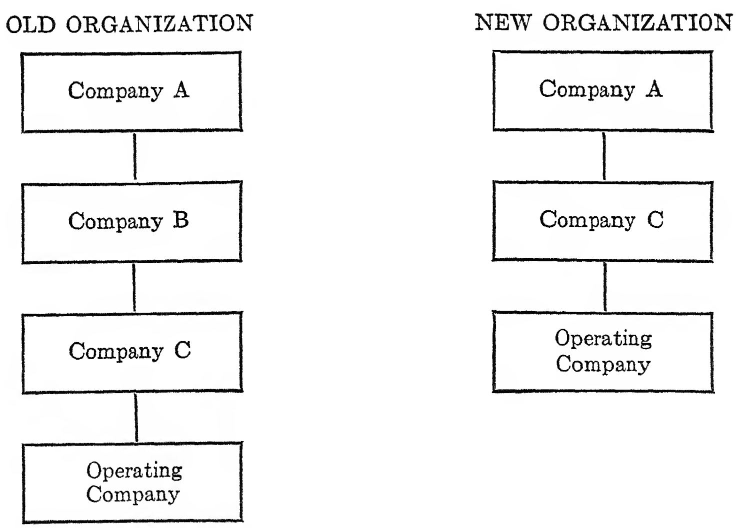
Holding-company systems must be simplified. As originally drafted, the Public Utility Act contemplated the elimination of all holding companies by January 1, 1940, unless it could be shown that they performed necessary services to their subsidiaries. As finally enacted, the law provides that a holding company cannot control more than one integrated system unless: first, the additional system cannot be operated separately without the loss of substantial economies; second, all systems operated by one company are located in reasonably contiguous areas; and third, the combined system is not so large as to impair the advantages of localized management, efficient operation, or the effectiveness of regulation. The effect of these qualifications is that a holding company must usually confine itself to one system in a limited geographical area. In any case, the holding company cannot build up a pyramiding of companies beyond three steps. As the Act states, the Commission must require that each registered holding company "cease to be a holding company with respect to each of its subsidiary companies which itself has a subsidiary which is a holding company."

The responsibility for formulating a reorganization plan was placed upon the holding companies which were required to submit their plans to the Commission for its approval or rejection. If a holding company failed to submit a plan, the Commission was au-

thorized to formulate one. The Commission was also authorized to examine the corporate structure of every registered holding company and its subsidiaries to determine the extent to which unnecessary complexities might be eliminated and voting power more equitably distributed among the holders of the various issues of securities.

Many methods of simplifying holding-company systems are being followed. The simplification of holding-company systems has proceeded rather slowly because of delay in the determination of the constitutionality of the Act, and as late as the autumn of 1945 the constitutionality had not been decided by the Supreme Court. However, many companies have not questioned the constitutionality of the law but have submitted plans of reorganization. The following are some of the methods being followed:

1. The intermediate or second degree holding companies have been eliminated. This has been accomplished by dissolving the intermediate holding company and distributing its assets to its shareholders, including the holding company at the top of the pyramid. The old and the new organizations are illustrated in the accompanying diagram.



One Plan of Holding Company Reorganization

2. A reorganization of the capital structure of the intermediate holding company was first effected, and this was followed by its dis-

solution. For example, if Company B, in the illustration given, had preferred stock and bonds outstanding, it could not immediately distribute its assets to its common stockholders because of the prior claims of the other security holders. One plan was to retire the bonds of the intermediate holding company with funds supplied by the sale of common stock to the holding company. Preferred stockholders were then required to convert their shares into common stock. The intermediate holding company then retired the common stock by paying out all securities owned as a liquidating dividend.[7]

3. Operating companies within the system have sometimes been consolidated to form more integrated units.

4. Isolated properties were sold to other holding companies in the area or to other financial interests.

5. The stock of certain subsidiaries whose ownership is prohibited to the holding company have been paid to stockholders of the holding company as a property dividend.

6. The holding company reduced the percentage of ownership of subsidiaries by the sale of a part of the stock. In this manner, the holding company was changed to an investment company.[8]

The Act has gone far to correct the abuses of the public-utility holding company and to establish effective regulation. When the reorganization of systems is completed, the holding companies should be an element of strength in our financial system instead of a menace as they were during the decade of the 1920's and the early 1930's.

Questions

1. What is a holding company? Is it always a corporation? What percentage of the outstanding stock does it own?

2. What is a consolidated holding company? A parent holding company? An intermediate holding company? A pure holding company? An operating holding company?

3. What was the first use made of the holding company? At what time?

4. What kinds of corporations are controlled by railway holding companies?

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[7] See reorganization plan of Commonwealth and Southern Corporation, S.E.C.: *Annual Report,* 1943, p. 29.

[8] See plan of United Corporation, S.E.C.: Holding Company Act Release No. 2907 (1941).

5. Why have railway holding companies been subjected to much less criticism than industrial and public-utility holding companies?

6. How does the Pennsylvania Company differ from the Allegheny Corporation?

7. What has been done to prevent the formation of other companies similar to the Allegheny Corporation?

8. When did the industrial holding company become a favored method of combination? What were the reasons for the formation of great holding companies during the years 1898 to 1901?

9. Would it be feasible for the United States Steel Corporation to become an operating company? The Standard Oil Company of New Jersey? Do you see any reason why the railway properties and the plants in foreign countries should be separately incorporated?

10. How does the holding-company device sometimes simplify problems of financing?

11. What advantages does the holding company have in administration? Could the same advantages be accomplished through the operation of various units as unincorporated branches?

12. What is meant by the statement that the subsidiaries of the American Telephone and Telegraph Company constitute a system?

13. Should one holding company own both public-utility and industrial corporations? Why or why not? Do the subsidiaries of Cities Service Company constitute a system?

14. What is the difference between a centralized and a decentralized holding-company system? What determines the type of system?

15. How does the use of the holding company limit liability?

16. How does the use of the holding company decrease the amount of the investment necessary to the control of a system?

17. How does the use of the holding-company device affect the earnings of the various security holders? How does it affect their risk?

18. What is pyramiding? Why is it objectionable?

19. In what ways may the subsidiaries of a holding company be "milked"?

20. What are the objections to the public-utility holding company?

21. What have the states done to regulate public-utility holding companies?

22. Why are "upstream loans" objectionable?

23. What has the Federal government done to regulate public-utility holding companies?

24. What public-utility holding companies are permitted under the law?

25. What methods have been followed in simplifying holding-company systems?

26. Why should any public-utility holding companies be permitted?

CHAPTER XXV

The Leased Company

The lease was a common method of combining small companies into larger operating units during the early days of the combination movement, but it is now used much less frequently than formerly. Railways especially have made much use of it, partly because the railway consolidation movement preceded the formation of large combinations in other fields, and partly because it is better adapted to railway combination than to industrial combination. Such systems as the Pennsylvania, the New York Central, the New Haven, the Boston and Maine, and the Southern lines have made extensive use of the lease, and many units of these systems are still operated under leasing agreements. Many leases have been replaced by other forms of control. In some instances the operating company has bought the stock of the lessor company and has voted a new arrangement; in others, the period of time for which the lease was to run has expired and the lease has not been renewed. In some cases the lease has been cancelled through receivership.

The lease is probably as well adapted to public-utility corporations as to railways, but it has been less used in that field. The principal reason is that public-utility combinations are of more recent development. The lease has serious disadvantages which were better realized when the movement for forming large public-utility corporations began to get under way. The troubles of the railways in the depression which followed the panic of 1893 clearly showed the danger of the fixed charges for rentals. Moreover, better methods of combination were available by 1900, since the states had liberalized their laws in the meantime, particularly with reference to holding companies.[1]

[1] Another arrangement among the railways is the trackage contract. This is an agreement by which one company shares with another the right to run trains over a part of its tracks. The trackage contract does not convey title to the property or an exclusive right to its use, since the owner of the property continues to operate its own trains over the tracks. The trackage contract is simply the grant of certain privileges for hire.

Among the industrial corporations, the lease has been extensively used by some limited types, particularly real estate companies and mining companies. It is not well suited to manufacturing enterprises which are characterized by frequent and marked shifts in prices and in consumer demand.

The lease provides that the entire properties of the lessor are to be taken over by the lessee. Not only are the land and equipment subject to the lease, but all inventories, supplies, receivables, and other properties are included. The lessee corporation also agrees to pay the debts of the lessor. The lessor corporation continues its corporate existence and retains the legal title to the property, subject to the leasing agreement. It ceases to be an operating company, and its activities are confined to the protection of the interests of its stockholders under the lease.

The lease usually runs for a very long period. If it runs for a short time, the practical difficulties involved in accounting for improvements, additions, and repairs and in making satisfactory adjustments to protect the interests of all parties are almost insuperable. However, it must be no more than a grant in years, for a lease in perpetuity would be equivalent to a sale of the property. Among the railways, the favorite term is 99 years, though in some cases the term is 999 years.

The compensation under the lease may be fixed or variable. If the compensation is fixed, it may be a stated amount each year to be paid to the lessor corporation. In many cases, however, the rental is stated as a certain rate of dividend on the outstanding common and preferred stocks of the lessor corporation, and it is customary for the lessee to make the dividend payments direct to the stockholders. In addition, the lease usually provides for a small annual payment to the lessor corporation in order to enable it to continue its corporate existence. The principal reason for maintaining its corporate life is to protect the interests of its stockholders and to see that the terms of the lease are complied with. Also, at the termination of the lease or its cancellation through receivership proceedings or otherwise, the lessor corporation would be required either to negotiate a new lease or to assume the management of the property. The expenses of maintaining the corporate life of the lessor corporation include directors' fees, franchise taxes, and the maintenance of the stock and other corporate records.

When the compensation agreed upon is variable, it may be stated as a percentage of the gross or net income. When the lessee cor-

poration owns all of the outstanding stock of the lessor, the rental is often 100 per cent of the net profit; in other cases it is frequently a smaller percentage. Among mining companies it may be a royalty upon each ton of ore removed from the mine. The early leasing agreements of the railways provided for a variable amount of annual rental, but the more recent agreements provide for a fixed payment.

Leasing agreements have been the subject of much litigation. If the payments for the use of the property vary with the gross or net earnings, disputes are likely to arise over the method of computing profits. In such matters as repairs, maintenance, depreciation, and obsolescence, there is much room for difference of opinion and it is difficult to provide for all the possibilities in a leasing agreement. Moreover, there is opportunity for the lessee corporation to make contracts whereby it profits at the expense of the lessor, since it is entrusted with the management of both its own properties and those of the lessor: for example, it may sell supplies to the lessor or make repairs on its equipment, or manufacture tools and rolling stock for it at high prices. The revenue from traffic carried over the two roads jointly may be divided between them in a proportion that unduly favors the lessee corporation.

When mining properties are leased with a rental which varies with the amount of ore taken from the mine, it is customary to provide for a minimum annual rental. The purpose of this provision is to insure that the lessee corporation will not permit the leased properties to stand idle. In the absence of the minimum annual rental, it would be to the interest of the lessor corporation to operate its own mines exclusively.

The lease agreement must provide for all contingencies. Experience with leasing contracts has shown that very great care is required in drawing them up if litigation is to be avoided. The agreement must make definite provision for the maintenance and repair of the property. The usual provision is that the lessee will return the property in as good condition as it was in at the time the lease was negotiated, except for wear and tear; it binds the lessee to keep the property in good operating condition and to renew all structures which by decay or accident become unsafe. If the lessee agrees to make "all necessary repairs," he is required to make whatever repairs are necessary for the use to be made of the property under the lease and not such repairs as might be necessary for a

future or different use after the expiration of the lease. If the rental varies with the net or gross income, the accounting methods to be followed in the determining of profits must be specified in detail. Provision must be made for any bonds which mature during the life of the lease, the usual provision being that their payment will be met by the lessor corporation from an additional issue of bonds, the rate of interest to be fixed by the lessee in consultation with the lessor. Taxes and interest on outstanding bonds or mortgages are usually paid by the lessee corporation directly. The lessor corporation usually has no income other than that received from the lessee, and the lessee prefers to make the payment directly because, by doing so, it is certain that the payment is properly made.

Cancellation of the lease if the lessee corporation fails to pay the rental for a certain number of months may also be provided for. The leasing contract may also be cancelled by a receiver. The appointment of the receiver does not cancel the lease, but the receiver may determine after a reasonable time whether he desires to assume the lease or to renounce it. If the lease is cancelled or the period of the lease expires, any improvements on the property pass into the hands of the original owners. Provision may be made in the lease for the valuation of any improvements, and for purchase of them by the lessor according to their value at the termination of the lease.

Leasing agreements are often combined with stock ownership. This is particularly true among the railways and public utilities, among which the leasing agreement has been most extensively used. The Pennsylvania Railroad Company, for example, holds all of the stock of a number of companies whose properties it has leased for a long term of years. In some cases, the stock was acquired after the lease was made; in others, a controlling interest in the stock was acquired earlier, the lease giving a more secure control of the property than the ownership of a part of the stock affords.

The lessee usually attempts to purchase the stock of the lessor corporation in the market from time to time. This practice is followed particularly when the period of the lease is about to expire and the property has increased in value during the period of the lease. The officers of the lessee company have intimate knowledge of the condition of the property, whereas the stockholders and the general public have not. They may therefore take the opportunity

to buy the stock of the lessor company before the termination of the lease and before the owners can learn how much their property really is worth.

The lease has several advantages. The principal advantages to the lessee company are as follows:

1. It makes centralized control possible. The lessee company has complete control of the assets of the lessor and can administer them and its own properties as a unit. The savings effected through combination go to increase the profits of the lessee corporation. The lessor corporation usually does not share in them, being limited to a fixed return.

2. It requires no new financing. The lessee corporation does not pay for the property as it would be required to do if it bought it outright, and therefore it does not have to sell its own bonds or stocks to raise funds. The lease thus makes it possible for the lessee corporation to extend its control much more rapidly than would be possible if it purchased or constructed new properties. For the same reason, the lessee corporation is enabled to control a large amount of property with a limited investment of its own.

3. It is comparatively easy to make a leasing arrangement. The stockholders of the lessee corporation do not need to confirm the arrangement; only the stockholders of the lessor corporation need approve it. And, naturally, it is easier to secure the approval of one group of stockholders than the approval of two groups. It is the general view that the unanimous consent of the stockholders of the lessor corporation must be obtained, though the courts of some states have held otherwise. If unanimous consent must be obtained, the lease may not be easy to arrange.

4. If the lease proves to be unprofitable to the lessee, the arrangement may be permitted to lapse when the lease expires. This easy solution is not possible if the stock is purchased or outright consolidation is effected by taking over of the assets. However, most leases run for long periods of time, and this advantage may be more theoretical than real. In most cases the lease can be terminated only by the procedure of a receivership.

To the lessor the advantage of the lease is that it assures a fixed return on his investment if the rental is a definite amount, as it usually is. If the amount of the rental varies with the earnings, the lessor receives a return on his investment commensurate with

the same position as a bondholder with a mortgage on the property. Moreover, the lessor is always confronted with the possibility that the lease may be cancelled through a receivership and that the property may be returned to him for his management and operation. A further disadvantage is that the lessee may permit the property to deteriorate or fall into a poor state of repair, despite the provisions of the lease.

Whether the leasing agreement proves to be good or bad to either the lessor or the lessee depends upon whether the earning power of the property increases or decreases. On the whole, it seems better to distribute the risk among all persons concerned by permitting the original owners to have a share of whatever improvement in earning power is made, and by requiring them to bear a part of any deterioration in the position of the property if that should occur. In other words, the leasing arrangement should be resorted to only when some less hazardous plan of consolidation is not possible.

Questions

1. What type of company has made most extensive use of the lease? Why?
2. How is the amount of the rental charge determined? Would the lessor prefer a fixed or variable amount of rent? Which would the lessee prefer?
3. Compare the position of the stockholder of a lessor corporation with a fixed rental with the position of a bondholder.
4. Why does the lease arrangement sometimes lead to legal controversies?
5. How does the purchase of the stock of the lessor corporation by the lessee simplify the legal and financial problems?
6. What are the advantages of the lease arrangement to the lessee?
7. What are the advantages to the lessor?
8. What are the disadvantages to the lessee?
9. What are the disadvantages to the lessor?

CHAPTER XXVI

Coöperatives

Coöperatives began as consumers' organizations for the purchase and sale of merchandise at local stores, and the movement is best known for its success in that field. Since all persons are consumers and since all consumers are invited to join a local coöperative, membership is open to all on the same terms. There is some merit in the contention that this type of organization is the only genuine coöperative and that other associations of persons or firms in an industry for mutual advantage are not coöperatives but class organizations. Nevertheless, associations of business firms in an industry have copied some of the principles of coöperation, and even though they do not subscribe to all of the principles, they are for convenience grouped together here under the head of coöperatives. Coöperatives thus defined may be classified as consumers', marketing, credit, and production or service coöperatives.

I. Consumers' Coöperatives

The consumers' coöperative cannot be classed as a form of business organization as that term is used in this book because it is not conducted for profit. However, it seems best to describe it, first, because the consumers' coöperative originally formulated and practiced the principles of coöperation which many other organizations have copied in part, and second, because the coöperative promises in no small measure to supplant other forms of organization in certain fields of business activity.

The consumers' coöperative began in Rochdale, England. In the year 1844, twenty-eight workers employed in the textile mills and other factories in Rochdale, despairing of increasing their wages at the mills, banded together to reduce their expenses by coöperative buying. Each person subscribed one pound sterling as capital; and with this meager sum they rented a place of business and purchased a small stock of flour, butter, sugar, and oatmeal. The co-

operative under the name of Rochdale Society of Equitable Pioneers was successful from the beginning, and after the first quarter of operation paid a dividend.[1] The movement spread throughout England and the countries on the continent, particularly the Scandinavian countries. Total membership is more than 100 million families in 39 countries. In the United States membership is about 2,500,000 persons.[2]

The capital of the consumers' coöperative is provided by limited-dividend stock sold to members. The dividend on the stock of the coöperative is limited to a fixed percentage, usually five or six per cent. Members purchasing from the coöperative pay approximately the same prices as those charged in other stores. Sales are usually for cash. After expenses are paid and the fixed percentage on the stock has been distributed, the balance is returned to the members in proportion to their purchases. This sum, called a patronage dividend, is not profit but a saving to the members. Most coöperatives use a part of such savings to publicize the coöperative movement and to support their association or league of coöperatives.

All members of a coöperative are required to purchase at least one share in the association, though they may purchase more than one share. Non-members are permitted to make purchases from the coöperative, but their patronage dividends must be applied to the purchase of shares until the stock has been paid for. The price of the shares is usually pegged at par value through the policy of the coöperative in selling and also in redeeming its shares at an established price. No buyer will pay more than that amount and no seller will take less.

The coöperative movement has spread beyond the field of retail selling. Coöperation usually begins in any community with retail selling because this activity is closest to the members. As more coöperatives are formed, a number of groups federate to organize a wholesaling enterprise on a coöperative basis. The coöperative wholesale establishment, which is owned by the distributive societies and is conducted in their interests, buys from manufacturers and sells to its member retail coöperatives. The prices charged are the usual wholesale prices, and any savings above expenses are paid

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[1] Stuart Chase: *The Story of Toad Lane,* pamphlet published by the Coöperative League, 167 West 12th Street, New York, N.Y.

[2] C. J. McLanahan: *A Century of Consumer Coöperation,* pamphlet of the Coöperative League.

as patronage dividends similar to those paid by locals. As more groups are organized, the federated groups may eventually acquire the ownership of factories which are operated on a coöperative basis. In the United States, coöperatives now own and operate gasoline service stations, feed mills, fertilizer plants, refineries, and other factories.[3]

Three principles of coöperation are generally accepted. From the beginning of the coöperative movement at Rochdale, the following principles have been followed by all coöperatives:

1. Membership is open to all persons regardless of race, religion, sex, or other qualification. One of the Rochdale Pioneers was a woman, and women have at all times been admitted on equal terms with men.

2. Each member has one vote, and no member has more than one vote regardless of the number of shares owned. This provision assures democratic control.

3. Returns on capital are limited to a fixed percentage. The interest paid on the stock is not regarded as profit but is considered as compensation for the use of capital.

In addition to these three principles, sometimes called the Rochdale principles, consumer coöperatives now are agreed on the following additional policies:

4. Each coöperative should appropriate a part of its funds for promotional and educational work.

5. Sales should be for cash and not on credit.

6. The usual or customary retail prices should be charged (or wholesale prices in the case of a coöperative in wholesaling).

7. A part of the savings effected by the coöperative should be set aside as a reserve to stabilize the patronage dividends and to provide for unforeseen losses.

8. Employees should be fairly treated as to wages, hours of labor, and working conditions.

The consumers' coöperative has not had as great success in the United States as might be expected. One reason has been the lack of stability in the population of many communities. When people move about from place to place or when they do not feel them-

[3] *Ibid.*, p. 4.

selves permanently established in a locality, they are not inclined to associate themselves with a coöperative enterprise. The coöperative movement has also suffered at times from its association with some other venture, such as a farmers' union. Coöperatives have also had to compete with the chain store which has been operated on an economical plan. Furthermore, as compared with chain stores or even independent stores, many coöperatives have not been well managed. One advantage of the coöperative is its exemption from income taxes. It does not pay an income tax because it earns no income but merely effects savings for its members. The consumers' coöperative, if well managed, has great possibilities.

II. Marketing Coöperatives

A marketing coöperative is an association of independent businesses for the marketing of their products on a joint basis or for the conducting of some of their advertising or other sales activities on a joint basis. Two kinds of marketing coöperatives will be described in the present chapter, coöperative chain stores and agricultural coöperative marketing associations.

Coöperative chain stores may include both retailers and wholesalers in one organization. A coöperative chain of stores is an association of independent retailers or wholesalers organized to secure certain advantages for the members, such as buying in large quantities, coöperative advertising, reduction of credit risks, and improved retail-store management. In some cases membership in the coöperative chain is restricted to retailers; in others wholesalers are admitted along with retailers. Both the retailer type and the retailer-wholesaler type are purely voluntary. The owner of the store retains his ownership and control while making contracts with other retailers, or with a wholesaler, for his purchasing and other types of service. Sometimes the contracts are binding in nature, while in other cases they constitute very loose agreements with no formal contract.[4]

Grocery stores began to form coöperatives as early as 1887. At first the wholesaler stood by and watched the struggle of the independent retailer against the large chain store. Ultimately, however, he began to realize that he had a vital interest in the affair; for if the independent retailer were crowded out or the volume of

[4] Federal Trade Commission: *Coöperative Grocery Chains,* Senate Document No. 12, 72d Cong., 1st Sess., 1932, p. 6.

his business seriously reduced, the wholesaler who served the retailer would find the volume of his business reduced also. In about 1916, therefore, the wholesalers began to assist the coöperative movement, and in many instances they took the initiative in organizing retailer-wholesaler chains. The movement for the organization of both retailer chains and retailer-wholesaler chains made great headway after 1925.

Coöperatives have also been organized by drug and hardware stores. The first coöperative chain of drug stores was organized in 1888 and the first coöperative hardware chain in 1906. Chains in these two fields of merchandising usually do not include wholesalers, and many of them confine their activities to buying. The discussion which follows has particular reference to coöperative grocery chains.

Coöperative chains differ widely in their activities. Some chains of both types limit their activities to coöperative advertising. Some carry on a few other activities such as purchasing and warehouse operation. Some conduct a wide range of activities, including the supervision of various details of store management. The retailer-wholesaler chains usually carry on more activities than the retailer chains.

The Red and White chain is an example of the retailer-wholesaler type. It includes a number of wholesalers who purchase through the Red and White Corporation in which the wholesalers own stock. The corporation controls a varied line of private brands made by various manufacturers under contract. No salesmen are employed either by the manufacturer in selling to the wholesaler, or by the wholesaler in selling to the retailer. The retailer must purchase his groceries exclusively from a wholesaler member of the chain. The wholesaler supervises the arrangement of the store of the retailer, the display of merchandise, the shelving, and other features of layout. The wholesaler in turn is guided by directions from the Red and White Corporation. Advertising is done by the wholesaler. The retailer pays a service charge for the advertising and also makes a cash deposit for the use of a sign supplied by the wholesaler. Most of the stores use the cash-and-carry plan.

The chains are financed in a number of ways. The retailer chain often charges an initiation fee. In addition members may make a cash deposit and pay weekly or monthly dues. Some of the chains are corporations and require the members to purchase a stated amount of stock. The stock may pay a limited percentage in

dividends, or it may pay no dividends with any surplus being used to provide better service or to make a refund to members in proportion to patronage received from them.

Most chains regularly use leaders. Leaders are usually changed from week to week but may be used only one or two days a week. Advertised leaders must be sold at the prices fixed. In the wholesaler-retailer chains, the wholesaler is required to offer one or two items each week at special prices, and the retailer in turn sells them for less than the usual margin of profit.

Most chains have their private brands of merchandise which they feature, though such merchandise is not necessarily offered at special prices. The advantages of private brands are, first, that they are not subject to price cutting by competitors, and second, that customers may be induced to shop at the store in order to buy the private brands.

Membership in the coöperative chain has definite advantages for the retailer. The advantages are, first, that the retailer may buy his merchandise at lower cost as a result of larger volume, second, that he receives assistance in store management, and he benefits from consumer goodwill associated with the uniformity and quality of service offered. While enjoying these advantages, the retailer retains the ownership and control of his store.

The disadvantages of membership in a coöperative chain are principally mismanagement of certain chains and the ill will that may be associated with chain stores in general. Some retailers prefer to conduct their stores in accordance with their own ideas and policies.

Membership in a coöperative chain has many advantages for the wholesaler. Through the coöperative chain, the wholesaler is able to sell at low cost, since many selling expenses are eliminated. Contracts with the retailers assure the wholesaler an outlet for brands of merchandise controlled by him. Through advertising and store management, the wholesaler is able to assist the independent retailers upon whom he relies for his business.

Coöperative marketing has many advantages for the farmer. Marketing associations have improved the bargaining position of the agricultural producer and increased the net returns to him by eliminating some of the wastes of distribution. They have also established grades for the product and thereby made it possible for the farmer to sell a standardized product instead of an unstandardized and ungraded product. Large buyers, such as com-

mission men and chain stores, are able to buy carloads of fruit and vegetables of uniform size and quality, for which the price is much better than it would be for the same amount of an ungraded product.

Agricultural coöperatives are organized in several ways. The nature of the organization depends upon a number of factors, among them being the nature of the product, and particularly its perishability; the territorial extent of the producing area; the territorial extent of the market; the character of the buyers, such as manufacturers, wholesalers, dairies, canners, or ultimate consumers; and the amount of financing required. There are six types of agricultural marketing associations:

1. *Independent local organization.* The independent local restricts its membership to growers of one product in one locality. This is the oldest type of coöperative and was originally organized for the purpose of spreading the overhead of marketing or manufacturing over a large volume. This was true, for example, of coöperative creameries and dairies. The farmers pooled their milk and bore the expense and shared in the proceeds of the sales in proportion to their patronage. Similar plans were adopted by producers of such products as grain, livestock, fruits, vegetables, poultry, and wool.

2. *Federated organization.* The federated organization is an association of a group of locals in the same line of production. It represents a movement toward more centralized control of marketing activities. It has no direct relations with the individual farmer but merely with the local association. It usually does not take title to the product being marketed; neither does it assemble or pack the product, these activities being left to the locals. Instead, it frequently establishes grades for the product, adopts and advertises trade names, attempts to find new uses for the product, and otherwise attempts to increase the demand, sees to the marketing, and handles other problems of general interest. The central association advises the locals on problems of organization and management. It assists in the standardization of varieties, and it often gives valuable advice in the selection and care of the seed, the care of the crop, and the proper methods of harvesting. It is also able to distribute the product between markets and to control the time of movement to markets. Among the well-known coöperatives organized as federations are Land O'Lakes Creameries, California

Fruit Growers' Exchange, Florida Citrus Exchange, Michigan Fruit Growers' Exchange, and the California Walnut Growers' Association.

3. *Centralized marketing association.* This association is composed of growers rather than locals, and makes contracts directly with individuals. It performs the functions of both the central association and the local. Through its representatives it sees to the assembling, grading, packing, and selling of the product. It takes title to the product and does whatever financing is required in the marketing. Through the centralized association, the produce of all growers is pooled and expenses are shared according to the volume sold. Among the well-known coöperatives of this type are the Sun-Maid Raisin Growers, the Georgia Peach Growers' Exchange, the Sowega Melon Growers' Association, and the Burley Tobacco Growers' Coöperative Association.

4. *Collective bargaining association.* This resembles a trade union in that it merely bargains with buyers for the price of the product. Usually it does not arrange the individual sale; neither does it take title to the product or handle it. The essential feature of the collective bargaining association is that growers in a certain territory contract to deliver their product to the local buyer only at a price fixed by the association, the price being determined by negotiation with local consumers or canners of the product. This type of organization is found in the marketing of highly perishable products such as milk and cream, the delivery of which is made to a dairy; and peaches, pears, cherries, and other fruits, the delivery of which is made to a local canning or packing company.

5. *Terminal sales agency.* The terminal sales agency operates as a commission merchant for the members, selling the produce consigned to them and charging regular commission rates. At the end of the year, whatever remains after expenses have been paid is remitted to the members in proportion to their patronage. This type of association is employed in the marketing of livestock and grain and certain types of fruits and vegetables. Well-known examples are the National Livestock Marketing Association and the Federated Fruit and Vegetable Growers.

6. *The national sales agency.* This form of coöperative organization is a combination of two other forms, the terminal sales agency and the local or federated organization. It is an association of locals or federations to provide a national sales agency which

operates in many markets. It has a definite membership, like the federation, but it conducts its operations from the market rather than from the producing area. National sales agencies have been organized to assist in the marketing of cotton, grain, livestock, fruits and vegetables, wool, and pecans.

In addition to the coöperative marketing associations, many service associations have been established to render service to the marketing organizations or to their members and families. Among the associations of this kind are plants for processing farm products, community warehouses, coöperative truck lines, coöperative electric power systems, mutual telephone systems, farmers' mutual insurance companies, and mutual irrigation and drainage systems.

Coöperative marketing associations are regulated by special legislation. For many years agricultural marketing associations were regulated by the usual incorporation laws, but most of the states have now enacted special laws providing for their organization. The earliest of these, passed in Michigan in 1865, was limited in scope and granted few privileges. As this type of enterprise has grown in public favor, the provisions of the laws have been broadened to permit coöperative enterprises in many fields of production and have also become less rigid in their requirements. Non-stock coöperative organizations were first legalized in California in 1895. In 1917 the Department of Agriculture proposed a model bill providing for coöperative marketing associations, and this has now been enacted into law in almost all of the states. It authorizes the formation of associations along the various lines already described in this section.

The progress of the farmers' coöperative movement in the 1890's and the first decade of the present century led to the charge that the agreements constituted a restraint of trade, and several associations were sued under the Sherman Antitrust Act of 1890 and the antitrust laws of the various states. The agitation resulted in the insertion of a clause in the Clayton Act of 1914 which stated that nothing contained in the antitrust laws should be construed to forbid the existence and operation of agricultural or horticultural organizations instituted for mutual help, provided they were non-stock societies and were not conducted for profit. But since many farmers' marketing organizations had capital stock, the law did not entirely relieve them of the liability of prosecution. The law was further liberalized by the Capper-Volstead Act of 1922, which

declared that farmers might organize marketing associations either with or without capital stock, provided: (1) that no member has more than one vote because of the capital paid in, or (2) that the association does not pay dividends on its stock of more than 8 per cent per annum.

III. Credit Coöperatives

Credit coöperatives pool the savings of the members and invest or lend them for their mutual advantage. Well-known examples are credit unions and mutual insurance companies. These institutions do not have stock but are at least in legal theory owned and operated by the persons who supply their funds.

Credit unions are formed for mutual advantages in saving and lending. Credit unions are usually organized among persons or groups having some other bond of association, such as membership in a church or employment in a factory. Savings are paid into the common fund from which loans are made to members at a stipulated rate of interest. Any amount earned above expenses is paid to the members supplying the funds. This plan affords the members with a good method of putting their savings to work while providing loans at a lower rate of interest than would be required on loans from commercial lending institutions. The bond of unity among the members reduces the credit risk and makes possible the lower rate of interest. Credit unions have had a marked development in factories and large retail stores since 1929 because of the losses sustained by holders of corporate securities. It is now generally considered unwise for a factory worker to put his savings into the common stock of his company. The reason is that if his company is adversely affected by a depression in business, his savings may melt away at the same time that his wages may be reduced or he may lose his job. The credit union affords a type of saving that is more nearly in line with the requirements of the worker.

Mutual life insurance companies are coöperatives. A mutual life insurance company is one which is owned by the policy holders and is operated on a coöperative basis. Such a company has no capital stock, and its principal source of funds is life insurance premiums. The life insurance contract is for the life of the insured and therefore may extend over a long period of years. Under most forms of contract, the insured agrees to pay a level premium, that is, the same premium each year for the duration of the contract.

However, the risk of mortality is not the same each year but increases with advancing years and particularly at advanced ages. The level premium is computed with an allowance for the increasing mortality with the result that the insured pays more during the early years of the policy than is required to meet mortality claims and to pay the expenses of the company. The additional sums collected constitute the legal reserve behind the policy and are the principal source of funds for life insurance company investments.

Since the life insurance contract may extend over a period of seventy-five years or more, it is impossible for the insurance company to determine precisely the premium required to pay expenses and to meet mortality claims. Consequently, the premium is fixed at a larger amount than is necessary, and any amount above mortality claims, expenses, and the legal reserve belongs to the policy holders. This sum is not income but a saving. Payments to policy holders from the savings of the company are usually called dividends, but they are in fact a return to policy holders of excess sums collected from them. There are three principal sources of such dividends: (1) expenses may be less than anticipated, (2) mortality experience may be favorable due in large part to the advance in medical knowledge and a better understanding by people generally of hygiene, and (3) interest on invested funds may be more than the rate contemplated. The company may have an unfavorable experience in any of these three respects, but most companies have been sufficiently conservative in their estimates that they are able to effect a saving each year.

Many life insurance companies began as stock corporations and later changed to mutual companies by redeeming their stock. Others, among them the New York Life Insurance Company, were mutual companies from the beginning. A stock company writes insurance at a fixed premium and contemplates that it will earn a profit by collecting more than amounts necessary to meet mortality claims, expenses, and legal reserve requirements. Some stock companies write insurance policies which permit the policy holder to participate in the savings and other policies in which the policy holder does not participate in the savings. The first type of policy is participating and the second is nonparticipating. In order to write the two types of policies, the company is required to keep records which show all income and all costs and expenses separately for each type.

Since in legal theory the policy holders own and control the

mutual company, they have the right to elect the board of directors. Meetings of policy holders are held once a year for the purpose of electing directors and transacting other business. Various methods are used to notify policy holders of the meetings. Some companies print the notice of the time and place of the meeting on the back of the premium receipt which the policy holders receive at some time during the year. Others publish notices in newspapers in the capital cities of the various states where policy holders live. Some send notices to their agencies which in turn notify policy holders by mail or by personal solicitation. Some companies permit policy holders to vote by proxy, and they solicit signed proxies in the name of the management. Others do not permit proxy voting under any conditions and require the policy holder to attend the meeting in person if he wishes to be represented.[5] Regardless of the method followed, the number of policy holders represented at a meeting is never large.

The method of nominating and electing directors of mutual life insurance companies is prescribed by state law. The New York law governs most of the companies. It provides that the existing board of directors may nominate an administration ticket. Other policy holders may make nominations provided, first, they petition the superintendent of insurance for a list of policy holders, second, they present a petition for their slate signed by one-tenth of one per cent of the qualified voters, and third, they file their petition five months before the election. If independent nominations are made, the company must mail every policy holder a ballot containing the names of the two slates of candidates.[6] However, the difficulties of filing a competing list of nominees are very great. The managements of large mutual life insurance companies are in fact self-perpetuating.

Life insurance companies play a very significant role in our economic life. They are important not only for the protection and the security which they afford policy holders and the beneficiaries of the policies, but also for the funds which they supply to industry and to government. The largest company is the Metropolitan Life Insurance Company which has assets of more than four billion dollars. The Prudential Life Insurance Company has assets of 3.5 billions. Sixteen largest companies own about 21 billion dollars of assets. Their investments consist largely of United States Govern-

[5] Hearings before T.N.E.C., Part 4, *Life Insurance*, p. 1554 (1939).

[6] T.N.E.C. Monograph No. 28: *Study of Legal Reserve Life Insurance Companies*, p. 14, Washington, 1941.

ment bonds, city real estate mortgages, public-utility bonds and preferred stocks, railway bonds, loans to policy holders, and bonds of counties and other political subdivisions.

Many fire and casualty insurance companies are stock corporations, but even in that field mutual companies are important. The mutual fire insurance company writes insurance for a premium of about the same amount as that charged by the stock insurance corporation; and after it has paid losses and expenses and has set up a reserve against unexpected losses or contingencies, it refunds to policy holders whatever remains as a participating dividend. A number of mutuals are operated by farmers and by factory owners, and some mutuals write automobile insurance and casualty insurance in addition to providing fire protection.

IV. Production or Service Coöperatives

The production or service coöperative is an association of businesses which produce goods or render services for sale to consumers for a profit. The purpose of the association is to facilitate the conduct of business by the members or to render a service to them on a coöperative basis. The association itself does not make a profit but charges admission fees or dues in the amounts necessary to render the services desired by the members. Three examples are cited in this chapter: (1) the coöperative taxicab association, (2) the stock exchange, and (3) the news-gathering association.

Taxicab owners have organized coöperative associations principally to meet problems arising from competition with other methods of transportation. The business of city transportation is highly competitive. The independent taxicab owners have to compete not only with the corporation owning a fleet of cabs, but also with streetcars, buses, sight-seeing vehicles, and the privately owned automobile. The transportation industry thus presents problems with which the individual owner is not prepared to cope, and it is to secure the advantages of a large organization, while retaining the ownership of the cab, that individual taxicab drivers have become associated as coöperatives. Associations of taxicab owners operate in a number of cities; in some cities they constitute the principal taxicab organization, while in other cities they exist along with corporate-owned fleets of cabs.

The taxicab association offers many advantages. Each driver owns his cab and receives just what income he is able to make by his

own initiative, but is relieved of the problems arising from the public relations of the industry. For example, traffic regulations, such as parking and driving rules and regulations prohibiting taxicab-cruising for passengers on certain busy streets, may seriously injure all taxicab drivers. Public-utility commissions, in fact, are under pressure from the owners of street railways to curb taxicab operations in various ways. The independent taxicab owner needs some organization, therefore, to represent him in the discussion of these problems.

Taxicab concessions at railway stations, hotels, and other public places are usually let to organizations that can guarantee protection to the patron and can assume responsibility in case of accident. An individual would have difficulty in getting such concessions, but an organization may get them for him.

The large organization can build up a customer goodwill. Goodwill is very important in the taxicab business, for the public prefers to patronize an organization in which it has confidence. Careful driving is very important. Moreover, it is possible to advertise the name and telephone number of a large organization, whereas it would be useless for an individual to attempt to make his name and telephone number familiar to the public.

The association usually owns a service station where gasoline and oil are sold to the members at cost. This constitutes a worthwhile saving to the driver who uses his automobile continuously. Arrangements are sometimes made with garages whereby the owner has his repairs made at a reduced rate. Through the association the members arrange for mutual insurance against public liability for damages to property or to persons. Legal service in defending the members against damage suits is also provided on a mutual basis. Some associations assist the members in the purchase of automobiles, making it possible for them to pay for their cabs by small monthly payments.

The association is financed by initiation fees and dues. Since some owners wish to operate a number of taxicabs, more than one type of membership may be provided, with a different initiation fee required for each. Monthly dues are paid according to the number of cabs owned and operated. Part of the money from dues goes into a fund to cover the general expenses of the organization, and part of it is paid into a second fund to meet damage claims against the members. Sole responsibility for accidents rests with the individual members, the association merely acting as insurer to

the amount of the fund with a definite limitation upon its liability on account of each member.

The stock exchange is a form of coöperative. A stock exchange is an association of dealers or brokers in securities. The purpose of the exchange, as stated in the constitution of the New York Stock Exchange, is to furnish rooms and other facilities for the convenient transaction of business by the members, to maintain high standards of commercial honor and integrity among the members, and to promulgate and inculcate just and equitable principles of trade and business. There are twenty-four stock exchanges in the United States, of which nineteen are sufficiently important to be registered with the Securities and Exchange Commission. Five exchanges are exempt because their activities are local and not national in importance.

The New York Stock Exchange is the oldest and by far the most important exchange in the United States. It began in 1792 when a group of brokers dealing principally in the obligations of the United States Government and the stock of the First Bank of the United States drew up an agreement prescribing methods of doing business. Their meeting place was in the open beneath a tree in lower Wall Street. In 1817 when the number of securities traded in had increased to thirty, a formal organization was perfected. At the present time membership is limited to 1,375; and since there are no "unissued memberships," anyone desiring to become a member must purchase a membership or "seat" from a retiring member or from the estate of a deceased member. The candidate for membership must also be formally elected by the Exchange which gives its approval only after it has been satisfied as to the financial responsibility and the honesty and integrity of the applicant. Corporations are not permitted to become members; and if a member is a partner of a brokerage firm, he alone may represent the firm on the floor of the Exchange. Partners of member firms who do not own seats in their own names are classed as allied members, and they are subject to the disciplinary powers of the Exchange.

Members holding seats in their own names are of several classes. Commission brokers are members who buy and sell for a commission. They have offices in one or more cities. Specialists confine their activity to the purchase and sale of one security. They remain at one of the posts on the floor where the security is traded, and most of their business is done for other members of the Exchange. Odd-lot brokers buy and sell in less than the standard 100-

share lots. Their business is also done for other members who limit their own trading to lots of 100 shares or multiples of 100. Floor traders are members who buy and sell on the floor of the Exchange for their own profit or loss instead of buying and selling for a commission. Inactive members are those who do not appear on the floor of the Exchange at all. Such members buy and sell through commission brokers, and because of their memberships are allowed a lower rate of commission than the charge made to others.

The New York Stock Exchange is not a corporation but an unincorporated association. The administration was reorganized in 1942 to provide more centralized authority and to give greater recognition to the public interest. Formerly it had a number of standing committees but most of them have been abolished. Administrative supervision is centered in a Board of Governors of twenty-four members. The public is represented on the board by three members, one of whom is President of the Exchange. The three public representatives cannot be members of the Exchange or partners of firm members. The board meets weekly to consider applications for listing of securities, nominations for membership including allied membership, cases of alleged violations of the rules of the Exchange, and other questions. Administrative affairs are handled by the president and his staff. A committee of the Board of Governors, called the Advisory Committee, assists the president in dealing with problems as they arise. Membership on the Advisory Committee rotates with at least one member retiring each month. The committee consists of three members of the Exchange and three allied members appointed for terms of three months. The Advisory Committee may censure members for minor infractions of the rules and it may impose fines not exceeding $250. Serious violations of the rules are dealt with by the Board of Governors.

Some of the departments of the Exchange are organized as corporations whose stock is held in the names of trustees for the members of the Exchange. These corporations are the Stock Clearing Corporation which handles the work of clearing money and securities and settling balances between the members, the New York Quotation Company which supervises the collection of the prices of transactions on the floor and their distribution to members by tickers, and the New York Stock Exchange Building Company which holds title to the real estate and equipment owned by the Exchange. In all of its organization and in its regulations for trading in securities, the Exchange is subject to the Securities and

Exchange Commission in accordance with the provisions of the Securities Exchange Act of 1934.

The Associated Press is a coöperative news-gathering organization. There are three news-gathering coöperatives, but the Associated Press is by far the largest. The other two are the United Press and the International News Service. Many newspapers are members of more than one service.

The Associated Press is a corporation with about 1,274 members which are organized as single proprietorships, partnerships, corporations, joint stock companies, and partnership associations. The Associated Press gathers and prepares for publication information, news, and feature services for its members through its own activities, and it also acts as an instrumentality for the exchange between the members of news and information gathered by each of them. It maintains offices in more than 250 cities of the world with a staff of 7,200 employees. To cover national elections it employs more than 65,000 workers. It maintains a financial news service with 200 writers and statisticians. It leases and operates a transatlantic cable and a network of telegraph wires throughout the United States. By contract with similar associations in England and other countries, it is entitled to receive news gathered by those agencies for transmission to its members. In addition to news, the Associated Press supplies its members with pictures, feature stories, cartoons, comic strips, and departmental features.[7]

The Associated Press is managed by a board of directors which is authorized to select officers and employees and to fix their compensation. The board also determines the nature and the extent of the news services. It apportions expenses among the members and levies assessments upon them. It may fine or suspend services to any member for violation of its by-laws or other regulations. Membership on the board is for a three-year term, though the directors are usually reëlected and serve indefinitely. In the election of directors, each member is allowed one vote, but bondholders are also allowed to vote provided they have waived the right to interest on their bonds. Each bondholder has one vote for each $25 in bonds with the maximum number of votes to one member limited to forty. The corporation has no capital stock, and major control is vested in the bondholders who have about 89 per cent of the voting rights. The bonds are held by members, most of them having been issued by the present corporation in exchange for the stock

[7] Complaint of Department of Justice against the Associated Press *et al.* (1942).

of the predecessor corporation when the present company was organized in 1900. In 1928 a subscription of a few additional bonds was permitted in order to extend voting privileges.

Until 1945, membership in the Associated Press was strictly limited. A membership could be acquired by purchase or by the creation of a new membership following application to the corporation. Prior to 1928, any member had the right to protest the admission of anyone provided the protesting member and the applicant published or planned to publish a newspaper in the same territory and in the same field, that is, morning, afternoon, or Sunday. If the application was protested, it was submitted to the full membership; and it could be approved only upon an affirmative vote of four-fifths of the members. This requirement usually barred an applicant if his admission was protested. In 1928, following a criticism from the Department of Justice, the provision for admission was changed to require (1) that the applicant need receive only a majority of the votes, (2) that he pay Associated Press members competing with his paper a sum of money equal to ten per cent of all the assessments they have paid the Associated Press since 1900, and (3) that he persuade any corporation supplying him with exclusive news or news-picture service to furnish the same service to members of the Associated Press competing with his paper and to furnish the services on the same terms as they are supplied to him.

The revised procedure did not make admission less difficult; and in June, 1945, the Supreme Court affirmed an order of the District Court requiring an easing of the admission requirements. The Court said [8] of the limitations upon membership:

"The net effect is seriously to limit the opportunity of any new paper to enter these cities. Trade restraints of this character, aimed at the destruction of competition, tend to block the initiative which brings newcomers into a field of business and to frustrate the free enterprise system which it was the purpose of the Sherman Act to protect. . . . The Sherman Act was specifically intended to prohibit independent businesses from becoming 'associates' in a common plan which is bound to reduce their competitors' opportunity to buy or sell the things in which the groups compete. . . . When Congress has desired to permit coöperatives to interfere with the competitive system of business, it has done so expressly by legislation."

[8] Associated Press *v.* United States, 65 Sup. Ct. 1416 (June, 1945).

The Court was divided five to three in the opinion. While much was said by both the majority and the minority concerning freedom of the press, this decision indicates that limitations upon admission to any coöperative which amount to an exclusion are illegal. It may foreshadow a relaxing of admission requirements by coöperatives generally, including those of some trade associations.

V. Some Legal Phases of Coöperatives

Many coöperatives are subject to special legislation or to the supervision of designated agencies of the government. Agricultural coöperatives are organized under special provisions of state laws, while the stock exchanges are regulated in accordance with the provisions of the Securities Exchange Act of 1934. Mutual life insurance companies are organized under special provisions of the law and also operate under the supervision of the state insurance commissioner. Nevertheless there are certain legal provisions that apply to coöperatives generally.

In legal organization a coöperative is either (1) an unincorporated association, (2) a non-stock corporation, or (3) a stock corporation. The unincorporated association is illustrated by the New York Stock Exchange and many agricultural coöperatives. The Associated Press and the mutual life insurance companies are non-stock corporations. Some agricultural coöperatives are non-stock corporations and some are stock corporations. Consumer coöperatives and some agricultural coöperatives are stock corporations with dividends limited to a fixed percentage.

The unincorporated association is a group of persons or businesses organized for some purpose other than profit. There are two essential attributes of the unincorporated association: first, it is a group of persons and not a corporation, and second, the purpose is something besides profit.[9] If the purpose is profit, the organization would be a partnership. Since the unincorporated association is a group of persons rather than a person such as the corporation, it cannot sue in its own name but must sue in the names of all of the members. It cannot take title to property in its own name, but title is held in the name of one or more members for the use of

[9] For much of the information contained in this section, the author is indebted to L. S. Hurlburt: *Legal Phases of Coöperative Associations*, published by the Farm Credit Administration, Washington, 1942.

the association. In a few instances, however, the courts have treated the unincorporated association as if it were a legal person.[10]

The unincorporated association is formed by contract between the members and provision may therefore be made for any contingency which is the legitimate subject of contract, such as the qualifications of members, the limitations upon membership, the expulsion of members, the rights and duties of members, the officers to be elected, their terms of office, and their duties. The contract may consist of a duly adopted constitution or a constitution and by-laws. Members joining the organization subsequent to its formation may give formal assent to the constitution by signing their names to the articles, or they may give oral or even implied assent. In more formal organizations, members are usually required to sign their names in order that they may indicate their acceptance of the liabilities and obligations incident to membership.

Members may be admitted to an unincorporated association without bringing it to an end, but the association has full right to determine who its members shall be. Thus, if a person buys a farm on which there is a telephone furnished to a former member of a co-operative telephone exchange, the purchaser does not automatically become a member. The same is true of the purchase of a brokerage business from a member of a stock exchange. If members withdraw or are expelled, they are not entitled to compensation for fees paid or for any interest in the association unless such rights are provided by the constitution or by-laws. If an unincorporated association is dissolved, any property remaining after debts have been paid is distributed pro rata among those who hold memberships at the time of dissolution.

An important difference between the unincorporated association and the partnership is the liability to third persons. Members are liable only for initiation fees and such other fees or dues as are provided by the constitution or regulations of the association. They are not liable for the expenses of the association on contracts which they themselves did not make or authorize to be made. In some cases, however, it has been held that if the expenses were necessary

[10] In a case involving a labor union, the United States Supreme Court said: "The suable character of such an organization as this has come to be recognized in some jurisdictions, and many suits for and against labor unions are reported, in which no question has been raised as to the right to treat them in their closely related actions and functions as artificial persons capable of suing and being sued." (United Mine Workers of America *v.* Coronada Coal Co., 259 U.S. 344, 387 (1922).)

to the carrying on of the work of the association as stated in the constitution or by-laws to which they have assented, all members become liable for their share. The officers are personally liable for debts which they contract unless they include a provision in each contract to the effect that the goods or services being purchased are for the association and that the association alone is liable.

Nonstock corporations must be organized in accordance with state law. While unincorporated associations may be organized by contract without the aid of statute, nonstock corporations operate under a state charter and therefore must be organized with such powers and with such charter provisions as the law permits or requires. In most cases, membership in such a corporation is evidenced by a certificate which is transferable only with the consent of the governing body of the corporation or in accordance with such provision as may be made in the by-laws or provided by statute. Thus, a nonstock corporation can easily control its membership.

Nonstock corporations have the right to expel a member for cause even though no such provision is made in the charter. Recognized reasons for expulsion are offenses of an infamous nature against the law of the land and failure of a member to perform his obligations to the corporation. A member has the right to withdraw at any time and the consent of the corporation is not required.

The nonstock corporation is administered by a board of directors and by officers similar to those of a stock corporation. Usually the board is elected by the members with each member entitled to one vote. This is the method of the mutual life insurance company. In some cases voting is in accordance with special provisions such as those of the Associated Press.

Stock corporations issue stock with limited dividend rights. While nonstock corporations raise the necessary capital by initiation fees or the sale of memberships or by borrowing, a coöperative stock corporation sells stock which is entitled to a dividend of a limited or fixed percentage. Any income after expenses and dividends and the necessary reserves is paid to members as a patronage dividend. Instead of paying patronage dividends, however, the corporation may use such amounts to provide additional services to members or to reduce its charges. Some coöperatives, particularly agricultural marketing associations, issue two kinds of stock: voting stock sold to members and non-voting stock sold to others.

Membership may be closely guarded even though a coöperative

sells stock. The state law usually provides that before stock in a coöperative is sold, the board of directors must accept the prospective purchaser as a member. If the applicant is not approved, the corporation may purchase the stock at a stated price, which may be par plus unpaid dividends. Any such limitation upon the right of a stockholder to sell his stock should be stated on the face of the stock certificate.

The group rights of members of a coöperative are similar to the group rights of stockholders in other corporations. They may choose and remove directors, adopt and change the by-laws, require an accounting for the funds of the corporation, and examine its books, subject to such restrictions as may be necessary for the protection of the interests of the corporation. The powers and duties of the directors are also similar to those of directors in other corporations.

Coöperatives in business usually employ some but not all of the established principles of coöperation. The first principle of the Rochdale Pioneers that membership should be open to all on equal terms is usually violated. Instead, membership is limited to persons in the industry or business. Agricultural coöperatives limit membership to persons engaged in one branch of farming. The second principle of one member, one vote, is more generally observed; but some agricultural coöperatives permit plural voting on the basis of the amount of patronage or the size of the farm. Voting in the Associated Press, which regards itself as a mutual organization, has been very undemocratic. The third principle that returns on capital should be limited to a fixed percentage is usually observed; but the rate of eight per cent permitted by some agricultural coöperatives is so high that it almost amounts to a violation. Since most of the associations described in preceding sections do not measure up to these principles, they are coöperatives only within a very limited meaning of that word.

Questions

1. When did the coöperative movement begin? Where? For what reason?
2. How is capital supplied for consumers' coöperatives?
3. What is a patronage dividend? Is it income to the recipient?
4. What two kinds of dividends are paid by coöperatives?
5. What are the three principles of coöperation?

6. Why have consumers' coöperatives not been more generally successful in the United States?

7. What are the two types of coöperative chain stores?

8. What types of activity are carried on by coöperative chain grocery stores?

9. How are coöperative chains financed?

10. What are the advantages of the coöperative chain to the retailer?

11. What are the advantages to the wholesaler?

12. If you owned a retail grocery store, would you be willing to join a coöperative chain? Upon what factors would your decision depend?

13. What are the six types of agricultural coöperatives? Mention agricultural products for which each type is suited.

14. Are agricultural coöperatives monopolies? Why are they permitted or encouraged?

15. What two requirements must be met by an agricultural coöperative if it is to be exempt from the antitrust laws?

16. From what source are the funds of a credit union obtained? How are the funds invested or loaned?

17. How is a mutual life insurance company usually started? Why is capital stock usually considered necessary for the first few years?

18. What is the source of dividends paid by a mutual life insurance company? Do the dividends represent income to the recipients?

19. How are directors of life insurance companies elected? If a policy holder has several policies in the company, is he entitled to one vote for each policy? Are the holders of large policies entitled to more votes than the holders of small policies? Why?

20. What is the principal advantage to the owner of a taxicab in becoming a member of a taxicab association?

21. What is the legal organization of taxicab associations? Would any other form be feasible?

22. What is the purpose of the organization of stock brokers as an exchange?

23. What are the requirements for becoming a member of the New York Stock Exchange?

24. What are the classes of members on the exchange? What is an allied member?

25. How is the stock exchange administered?

26. Why have stock exchanges been brought under the control of the Federal government?

27. In what sense is the Associated Press a coöperative? What principles of coöperation has it adopted? Which principles has it not adopted?

28. How is a newspaper admitted to the Associated Press?

29. What is an unincorporated association? How does it differ from a partnership?

30. What is done with the property and funds of an unincorporated association when it is dissolved?

31. How does the unincorporated association control its membership?

32. Give examples of nonstock corporations. What are the advantages of the nonstock corporation as compared with the unincorporated association?

33. How do stock corporations control their membership?

CHAPTER XXVII

The Economics of Combination

The question of public policy toward large corporations and combinations in industry is at present a vital problem and it is certain to loom large in public and political discussion in the years ahead. It is a subject with many phases which are ever changing. The most important questions concerning our economic organization are: (1) To what extent is the American economy characterized by large industrial corporations and by monopoly? (2) What are the types of combination, from the point of view of products manufactured and manufacturing and marketing processes controlled? (3) What are the advantages of the large industrial combination over the medium-sized or small business? (4) Is the large enterprise usually more successful than the small or medium-sized business? (5) Why has the large combination not been more generally successful? These questions cannot all be answered to our entire satisfaction, and any conclusions must be subject to revision because of the march of events and particularly because of the growing power of the government over industry. Nevertheless, it seems necessary at least to inquire into the economic significance of the facts presented in the preceding chapters.

I. The Extent of Concentration in Industry

Concentration in industry has two phases, monopoly and large size. The two are not necessarily synonymous. A monopoly might be a relatively small business because the total demand for the product is limited or because the market is limited in area. Moreover, monopoly is itself a relative term because substitutes are available for most commodities or services. If the consumer cannot buy one food or one kind of cloth, he purchases another. Most monopolists must meet some degree of competition at some time or place, but complete control of a market is not necessary to a partial control of the price. Another factor which the monopolist

must consider is potential competition, that is, competition that would enter the market if the price should be increased too much.

Many industries are dominated by one company. Industries which were dominated by one company at the beginning of the Second World War included aluminum, shoe machinery, glass containers, optical glass, nickel, magnesium, telephone service, pullman cars, and local public service.[1] Some of the companies in these industries achieved their dominant position by virtue of their control of natural resources, others by control of patents, and others through the monopolistic nature of the industry. The telephone and the local public-utility services are now effectively regulated by Federal and local governments and therefore present no problem. The use of patents to dominate the glass container and other industries has been the subject of several complaints by the Department of Justice, but little has been accomplished because of the protection afforded the companies by the patent laws. The aluminum industry will be changed after the war as a result of the expansion of production facilities through government-owned plants and also as a result of the increased production of magnesium which is a competitor of aluminum for many purposes.[2]

Some industries are dominated by two firms. The control of an industry by two firms is called duopoly. Industries in which there were only two companies at the beginning of the war included telegraph service, bananas, plate glass, electric lamps, bookkeeping machines, air brakes, and sulphur.[3] The dominant position of the companies in these industries was also based upon patents, the control of a raw material, or the monopolistic nature of a service rendered. The two companies in these industries do not necessarily coöperate in the matter of prices or other phases of competition, but they may do so. Coöperation would be easy to effect and difficult for an agency of the government or customers to detect. Occasional coöperation is in fact to be expected in view of the ease of carrying out such a policy.

In many industries a relatively small number of firms account for most of the output. The report prepared for the Temporary National Economic Committee lists 121 important industries in

[1] T.N.E.C. Monograph No. 21 (by Clair Willcox): *Competition and Monopoly in American Industry,* pp. 68-98. Washington, 1940.

[2] In September, 1945, the R.F.C. announced that the aluminum plants owned by the government would be leased to companies other than the Aluminum Company of America in an effort to establish competitive conditions in the industry.

[3] T.N.E.C. Monograph No. 21, pp. 98-110.

the United States in which the four largest producers controlled more than 75 per cent of the output in 1937.[4] The following are typical of the industries included in the list:

REPRESENTATIVE INDUSTRIES DOMINATED BY A FEW COMPANIES

Product	*Number of Producers*	*Percentage Produced by Four Largest*
Snuff	4	100.0
Refrigerator Cabinets	11	98.6
Asbestos Shingles	8	97.4
Tractors, all purpose	11	90.6
Aluminum ware, cast	14	90.5
Milk Bottles	12	89.2
Hot-Rolled Steel Strips	14	86.0
Cigarettes	32	84.8
Adding Machines	9	83.1
Motors, 1 to 200 horsepower	40	79.4
Truck and Bus Tires	25	78.8
Canned Meats	24	76.5
Granulated Sugar	21	75.8
Trucks and Buses	82	75.3

In the industries in which a few producers hold a leading position, some kind of agreement for the elimination or the minimizing of competition is both possible and fairly common. This is accomplished through a gentlemen's agreement, often implemented by a policy of price leadership, or through a pool. The trade association may be the agency for effecting an agreement, or agreements may be reached directly. Aggressive and unrestricted competition exists in many of the industries, as members of the industry and also their customers will testify.

Many industries are characterized by a large number of companies. The report of the Temporary National Economic Committee lists 49 industries in which the four largest producers accounted for less than twenty-five per cent of the output. In fourteen of these industries the four largest producers accounted for less than ten per cent, in twenty-six industries the four largest produced less than fifteen per cent, and in forty-four the four largest accounted for less than twenty per cent. The smallest concentration was reported in women's, misses', and children's apparel, fur goods, the publication of books and music, lumber and timber products, men's and boys' clothing, knit goods, furniture, men's cotton garments, and house furnishings. Other important industries in which there are many companies are jewelry, confectionery, paper,

[4] *Ibid.*, p. 117.

stoves and ranges, toys and games, coffins and caskets, pottery, leather and rubber goods, and canned fruits and vegetables. In addition to these manufacturing industries, the service industries referred to in Chapter II are characterized by large numbers of companies. Wholesale and retail merchandising are other activities where large numbers of firms, many of them small enterprises, exist. Most of these industries are organized through national, sectional, or local trade associations.

The foregoing survey indicates a wide variety of conditions. Whether one concludes that production is concentrated in the hands of a small or a large number of firms depends upon the industry under consideration. While monopolistic control prevails in some industries, active and continuous competition characterizes many others.

II. Types of Industrial Combination

The large organization is usually justified on the ground that it brings economies which cannot be achieved by the small firm. The economies associated with the large company depend not only upon the size of the enterprise, but also upon the number of products manufactured or sold and upon the number of stages of manufacture or distribution under the control of one company. From the point of view of the position of the company in the industry, three types of combination may be distinguished. These are: (1) horizontal, (2) vertical, and (3) complementary. It is difficult to find any large company which typifies only one form of organization, for most companies illustrate two or three forms.

The horizontal combination is a combination of factories producing like products. For example, a combination of bakeries or of dairies, or a chain of retail stores, is a horizontal combination. The General Motors Corporation is often mentioned as an example of a horizontal combination because it manufactures a great many makes of automobiles, but it might be used to illustrate other types of combinations as well. Most combinations are at least in part horizontal combinations. Horizontal combinations illustrate the principle of *concentration* in industry.

The vertical combination is a combination of factories representing different stages of manufacture. It controls the production and fabrication of the raw material through various stages of manufacture. It is not necessary that the combination control

all the processes of manufacture and distribution from raw material to finished product, but many companies do so.

An example of a vertical combination is the United States Steel Corporation, which controls production from the mine to the steel beams or the wire nails or other fabricated products. It owns iron mines in northern Michigan and other states. It transports the iron on its railroads and in its ships to its pig-iron furnaces, in which the ore is smelted by means of coke made in its coke ovens from coal mined from its coal mines. It owns Bessemer converters, rolling mills, pipe and tube mills, wire factories, structural-steel plants, galvanizing and tinning plants, brass foundries, cement plants, and bolt and nut factories. This list is not complete but merely suggestive of the extent of the combination. Vertical combinations illustrate the principle of *integration* in industry.

The complementary combination is one which produces different commodities or services. Complementary combinations are sometimes called *allied* or *circular* combinations. Some produce a number of commodities which are manufactured by similar manufacturing processes, or which are marketed through the same channels of distribution. Other combinations have been formed by adding lines that seem to be only remotely related to the original products.

Many examples of complementary combinations may be found in the food industry. For example, the General Foods Corporation, which formerly sold Postum, now sells more than 60 other products, including Grape Nuts, Post Toasties, Jello, Baker's coconut, Log Cabin syrup, Maxwell House coffee, and Calumet baking powder. Best Foods also sells a number of products, such as pickles, relish, salad dressing, and pancake flour.

Complementary combinations may be found in many other fields. Remington Rand sells a complete line of office equipment, such as typewriters, adding and computing machines, filing equipment, and billing machines. The Glidden Company manufactures paint and varnishes as well as food products, and the International Harvester Company manufactures a varied line of farm machinery.

III. The Advantages of Large Size

Combinations are usually brought about as a result of the activities of promoters and others who make profits from it. Nevertheless, there is a real economic basis for the large company which

justifies it from a social point of view as well as from an individual point of view. This is not to say that every merger can be justified by economies to be effected, for many of them are poorly conceived and doomed to failure from the start. The point is that the combination movement as a whole is so universal throughout industry that it appears to be based upon advantages that go with the larger business units.

The advantages of large size are many, but in most cases only a few of them can be realized by the individual concern. The following enumeration of the advantages that go with size covers all types of combination.

The large combination enjoys many advantages in purchasing. Many vertical combinations are formed to effect economies in purchasing, such as:

1. *Greater certainty of the supply of raw material.* A company which manufactures a product composed of many parts finds it particularly desirable to control their manufacture. This was an important advantage during the war period when many supplies were scarce. Chain stores which owned slaughter houses had a decided advantage over independent retailers who were required to buy dressed meats in the market.

2. *The assurance of raw material of uniform quality.* The raw material may be better adapted to the uses of the company which controls its manufacture. Ability to control the whole process of manufacture from raw material to finished product permits of better planning of the design of the parts and of the product.

3. *Unification of purchasing departments.* The consolidation of two or more purchasing departments may permit of a reduction of the total cost. A reduction in the number of buying departments because of the consolidation of two companies also affects the selling organization of the companies which supply them with materials. Centralized buying by department stores, chain stores, banks, publishing houses, and hotels has materially reduced the need for salesmen throughout industry. A vertical combination that sells only to the ultimate consumer needs no purchasing department except for the first unit in the chain of manufacture, and no sales department except for the last unit.

4. *The purchase of large quantities.* In some instances quantity buying gives better prices and credit terms.

5. *Smaller inventories.* The pooling of the inventories of a number of small companies into a single large inventory permits of an appreciable reduction in the total inventory because reserve supplies to meet fluctuations in demand can be pooled.

The large combination has many advantages in manufacturing. Some of the advantages in manufacture are associated with the vertical combination, but more of them with the horizontal combination. Some of the advantages are:

1. *Saving in handling and reheating.* This is an advantage of the vertical combination in the iron and steel industry. When the blast furnace was separated from the converter, the pig iron was allowed to cool and then had to be reheated for the converter. The steel from the converter was again allowed to cool before going to the rolling mill and had to be heated again before being rolled into steel rails or structural steel. The waste involved by the separation of the processes was very early recognized. Long before the present great steel combines were formed, blast furnaces, converters, rolling mills, and tin plate mills were organized as separate departments of one establishment. To secure this advantage, all departments of a large plant were concentrated in one place.

2. *Specialization as between plants.* Specialization is an advantage when machinery must be changed to produce a different product. For example, in the manufacture of paper the machinery must be adjusted to the length or width of the paper. Specialization as between plants permits the machinery of each to be operated continuously upon one kind of paper without the labor cost and loss of machine-time incident to the making of the change. The same economy is alleged for combination in the steel industry. To secure this advantage a company must operate a number of small plants rather than one very large one.

3. *Utilization of scrap in the manufacture of by-products.* The packing plants are the classic example of this advantage of large-scale production. In the slaughter of cattle, for example, the large packers utilize many parts of the animal which would go to waste in small establishments, such as the blood for fertilizer and stock foods, the horns for glue, gelatin, and fertilizer, the glands for the manufacture of medicinal preparations, the cartilage for tallow and glue, the shin bones for bone oil and knife handles, and the hair for brushes. Even the hairs of the ears are clipped and used for artists' brushes.

In many industries the large plant has no advantage in the utilization of scrap. If the material is not perishable, it may be stored and disposed of by the small company. This is true in the metal-working industries. If the large company follows the policy of specialization as between plants, it loses any advantage that it would have over the small one in the matter of disposing of scrap.

4. *Reduction in the number of styles and sizes.* Under pressure of competition, producers frequently add new styles or sizes, and the number of lines is difficult to reduce if one manufacturer attempts to do it alone. A consolidation of the competing companies would make it easy to eliminate the unprofitable lines. However, a consolidation is not necessary to accomplish this purpose, for much has been done in the simplification of products by trade associations with the coöperation of the Bureau of Standards.

5. *Closing of high-cost plants.* It frequently happens after a merger is completed that the combination is able to close some of the higher-cost plants without any reduction in output. In many cases the reason for closing some of the plants is to reduce output and to raise prices.

6. *Saving on insurance.* A large company can carry its own risk of fire or other loss if its properties are widely scattered. To secure this saving, a company must own a great number of relatively small plants rather than a single large one. The net saving from insurance is not large.

7. *More effective use of patents.* Two or more companies owning complementary patents may pool them to the advantage of themselves and the purchasers of the product. Unless the patents are pooled, no one company may be able to manufacture the completed product. Airplanes, tanks, and shoes are examples of products whose manufacture is facilitated by patent-pooling.

A large combination has certain advantages in selling. The principal advantage of many complementary combinations is in the field of marketing. Distribution expenses are frequently larger than manufacturing expenses, and the reduction of selling costs is important. Many of the following advantages are peculiar to complementary combinations, though some of them may be enjoyed by other types of combinations.

1. *Reduction in number of salesmen.* The combination which sells thirty-five to forty items of food or drugs should be able to

solicit the wholesale or retail trade with a relatively small number of salesmen. A company which sells a large number of items, however, must put selling effort behind each individual product if it is to continue to secure its share of the business.

2. *Service to customers.* One of the advantages of having a complete line in a field like that of harvesting machines is that better repair service can be given customers at low cost. In another field, the consolidation of a number of vending-machine companies permitted all vending machines to be serviced by one department.

3. *Lower delivery costs.* This saving is important in the food and drug trade where stores may be served by one truck, from a single warehouse in each city.

4. *Saving in cross-freights.* The economy consists in making deliveries to the customer from the nearest factory. The saving is especially important when the product is bulky and the freight charge is a high percentage of the cost. However, if a company locates non-specialized plants near the consumer to save cross-freights, it cannot at the same time obtain the economies resulting from specialization as between plants.

5. *Seasonal dovetailing of products.* For example, a company producing a line of food products may concentrate on such items as nuts, oysters, and chocolate in winter, and salads, salad dressing, and ice cream mixtures in summer.

6. *Extension of the export trade.* A large combination frequently can maintain selling agencies and branches abroad when small companies could not do so.

The large company has certain advantages in finance. The financial advantages are as follows:

Greater stability of earnings. Stability of earnings may result from selling in markets over wide areas and also marketing a varied line of products. In some cases greater stability of earnings may result from control of prices received for the product or paid for raw materials.

2. *Better market for securities.* The large company may be able to sell its securities to advantage because they are bought and sold on the stock exchanges.

3. *Greater financial reserves.* Reserves may enable the large company to withstand the effects of industrial depression or other

financial reverses. The demands upon a large company during such times may, however, be correspondingly great.

4. *Credit at lower rates of interest.* If the large company can borrow at lower rates of interest, the reason may be that it is better known, has a record of earnings and dividends, lists its securities on the exchanges, and has a sufficient volume of notes, stocks, and bonds to carry the costs of marketing them to advantage.

The large company has certain advantages in administration. The greatest advantages in administration are to be achieved by the vertical combination, though some of them may be achieved by the horizontal combination. The advantages are as follows:

1. *Better industrial planning.* The vertical combination can budget for a large part of an industry and perhaps for an entire industry. It can eliminate speculative buying at the various stages of production, and assure each unit except the last one a market for its product, and also, except for the first one, a continuous supply of raw material.[5] Even the integrated business must assume the risks of fluctuations in the demand for the finished product. The available statistical evidence indicates that the large company has greater stability of prices and earnings but greater fluctuation in the volume of production and in employment.

2. *Productive scientific research.* The research work of such companies as the telephone and telegraph, the automobile, the oil, and the electric companies has proved most beneficial both to the companies and to society, but would have been impossible in an industry composed of small units.

3. *The exchange of information on costs.* A company operating several small plants can compare their costs and use the best operating methods and the best machines in all factories.

4. *Expert technical advice.* The large company can maintain an expert legal and technical staff whose services are available to all of the smaller units. This is particularly important in the public-utility and other fields in which there are technical problems.

Monopolistic control brings other economies. The savings which only a monopoly may effect lie principally in the field of

[5] For further development of this point, see Lawrence K. Frank: "The Significance of Industrial Integration," *Journal of Political Economy,* April, 1925, Vol. 33, pp. 179-195.

marketing. A part of the usual advertising cost, for example, may be eliminated if there are no competitors in the field, although a substantial amount of advertising would usually be necessary in order to hold old customers and to attract new ones; for without advertising, customers might cease to use the product entirely or they might find substitutes. A large number of salesmen may also be eliminated by a consolidation of competing wholesale companies or manufacturers if no competitors are in the field. In the wholesaler-retailer grocery chain store, for example, where the retailer contracts to purchase exclusively from one wholesaler, the wholesaler may eliminate all sales activity and direct his attention to informing the retailer of the qualities of products offered and ways and means of promoting their sale to the consumer.

Another advantage of the monopolist is that he may fix his price at the point that yields the greatest profit to himself. This does not necessarily mean a very high price, since high prices would limit volume. Neither does it always mean a low price, since a large volume at a narrow margin of profit may mean a small net income. Many monopolists have found also that the charging of very high prices encourages competitors to enter the field. This requires the monopolist to enter upon a price war to put the competitor out of business or else to buy out the competitor at his own price. Consequently, the monopolist may be content with a fair margin of profit at a comparatively low price.

Many social advantages may result from large size. The discussion of the advantages of large size cannot be confined to economies in production, distribution, administration, and finance, but must also include the broader national and social advantages. During the Second World War, the large size of American corporations and the relatively small number of firms in many industries greatly facilitated the arming of the country for war. Long before hostilities started, policy making and the ownership and control of production facilities were highly centralized in many industries. Large companies had the scientific staff, the laboratory facilities, and the proving grounds to develop and perfect the implements of war. Consequently, industry was able to shift rapidly from peace-time production to the manufacture of the engines of war and of supplies for the armed forces. If industry had been characterized by small shops and factories, the shift would have been impossible within the time allowed in such a crisis. In fact, the difficulties of the small business referred to in Chapter II arose in part from the fact

that it could not be quickly reorganized and fitted into the pattern of national organization for war.

During the postwar period, the organization of much of the productive capacity of the country into large-scale units promises to bring other national advantages. The production of goods and their sale in national and international markets are likely to be under strict governmental control throughout Europe and Asia for an indefinite period. This will be accomplished through cartels or other organization of industry as well as by government ownership. For American industry to operate in world markets through small units on a highly competitive basis would be a serious disadvantage to the American economy. It seems probable that increased coöperation of American industry and continued control by government are inevitable. What form the policies of the government will assume, it would be idle to predict, but the basis has already been established in the present organization of industry.

IV. The Efficiency of the Large Enterprise

If a large company has all of the advantages mentioned in the preceding section, it might be expected that it would always be more successful than the medium-size or the small company. The extent to which the large company is more successful than the small one is not easy to determine, even though many studies of the problem have been made. The difficulties are, first, that efficiency cannot be adequately measured by profits alone, and second, that the profits data are not completely reliable or comparable for different companies.

Several tests of efficiency are possible. Efficiency means the elimination of waste, which might be reflected in decreased consumption of materials in manufacturing, a small number of man-hours necessary to manufacture a unit of product, or some other such measure of production cost. This would be a good test of efficiency if detailed and comparable figures were available. Such costs, to be complete, should include the expenses of selling and general administration. Efficiency might also be measured by the remuneration of the workers employed by a company, for the efficient company might be able to pay a higher rate of wages. Such a test would also be inconclusive because the shift of workers from one plant to another would tend to equalize the rates of wages. There is, in fact, no evidence that the large company pays higher or lower

The profits as reported by different companies are not always comparable because of different bases of valuation of assets, different ways of charging depreciation of plant and equipment, different methods of inventory valuation, and other accounting difficulties. A further serious limitation is that it is impossible to distinguish between profits due to efficiency and profits due to monopolistic practices.

The large company has not been uniformly successful. Most of the statistical studies of corporate profits indicate that the large company is no more successful or is possibly less successful than the small company. Professor Dewing made a study of the earnings of 35 combinations before and after consolidation: [7] he found that the earnings of the separate companies before consolidation averaged 18 per cent greater than the earnings of the consolidated companies for the first year after combination; and the earnings for the first ten years after combination averaged 16 to 20 per cent less than the earnings of the separate establishments prior to their consolidation. Professor Summers made a comparison of the earnings of 1,130 companies from a wide range of industries over a period of thirteen years.[8] He found that the small companies made a higher rate of earnings on their investment than the large companies. He concluded that size in itself does not bring greater earning power.

The National Industrial Conference Board computed the rate of return upon the net worth of a number of large companies for several years following consolidation, to determine whether the rate of return increased as the economies of large-scale production were gradually realized.[9] It was found that the rate of return did not increase and that there was no indication that the large company had superior advantages. The conclusions were summarized in four propositions: (1) In a declining industry, mergers are unable to prevent the prevalent drift toward ruin. In an expanding industry both the small and the large company share in the general prosperity. (2) In time of depression, the earnings of large companies decline as do the earnings of smaller companies. (3) Some large companies have failed because of poor financial structure. (4) Mergers offer no substitute for competent management. It

[7] A. S. Dewing: "A Statistical Test of the Success of Consolidations," *Quarterly Journal of Economics*, 1921, Vol. 36, p. 84.

[8] H. B. Summers: "A Comparison of Earnings of Large-Scale and Small-Scale Industries," *Quarterly Journal of Economics*, May, 1932, Vol. 46, pp. 465-479.

[9] National Industrial Conference Board: *Mergers in Industry*. New York, 1929.

will be observed that the first and second propositions concern all companies in an industry, while the third and fourth concern the individual company.

The Federal Trade Commission made a comprehensive study of the relation of size to efficiency for the use of the Temporary National Economic Committee in 1941.[10] The Commission compared the costs and profits, stated as a percentage of invested capital, of a large number of companies in eighteen industries. The companies were grouped according to size, and 233 comparisons were made in different industries and in different years. The conclusions of the Commission are summarized in the following paragraph:

"In the 233 combined tests, large size, whether represented by a corporation, a plant, a group of corporations, or a group of plants, showed the lowest cost or the highest rate of return on invested capital in only 25 tests. In these combined tests, medium size made the best showing in 128 tests and small size in 80 tests. Thus, large size was most efficient, as efficiency is here measured, in approximately 11 per cent of the total tests, medium size was most efficient in approximately 55 per cent of the tests, and small size was most efficient in approximately 34 per cent of the tests." [11]

If there is any difficulty in accepting the results of this study as conclusive, it is that the Commission did not take into consideration the amount of the differences in size of companies and the increase or decrease in profits between groups. In the final figures of the Commission, a slight difference in size of company or rate of return is as significant as a large difference.

The result of the various studies appears to be a welter of confusion. The correct conclusion appears to be that size is an important factor in the efficiency of an enterprise, but it is not the only factor and sometimes is not the determining factor. The average rate of return appears to increase with size among small companies and even among medium-sized companies in many industries. Even if the rate of income does not continue to increase with an increase in the size of the company, the large company will usually have a higher rate of income than the very small one.[12]

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[10] Monograph No. 13: *Relative Efficiency of Large, Medium-sized, and Small Business.*. Washington, 1941.

[11] *Ibid.*, p. 14.

[12] This is the conclusion of W. L. Crum. See his *Corporate Size and Earning Power*, p. 230. Harvard University Press, Cambridge, Mass. (1939).

V. Disadvantages of Large Size

If the large company has not been uniformly successful, it does not necessarily follow that large size is a disadvantage. The reason for lower profits might be poor management of the individual company, losses from the ravages of nature or of war, and a host of other isolated causes. However, it may be true that after a company is large enough to enjoy the economies of large size, a further increase in size may actually result in an increase in costs.

In the large company much authority must be delegated. As the size of the business increases, the head of an enterprise must devote more attention to general policies and particularly to relations to the government, to competitors in the industry, and to customers. Labor relations may also require a large amount of his time and energy. Consequently, the details of management and even the formulation of many policies must be delegated to other persons. Unless delegated authority is combined with responsibility, it is ineffective. This means that systems of budgetary control, cost accounting, and business statistics must be installed as a check upon all officers throughout the organization. Such systems are expensive and less effective than direct supervision and control. A person who is acting under responsibility to another is also more inclined to avoid risks for fear of making a mistake. If he does the wrong thing, he may be criticized; but if he plays safe, he may be able to retain his position. In some cases, the profit is to be made by taking a chance.

In the large organization, small wastes may appear to be unimportant. An owner of a small enterprise can see the advantage of saving every dollar through the elimination of unnecessary expenses; but in a large company, the desirability of economy may not be so clear. If the expenses already run into the millions of dollars, an increase of a few thousands due to the addition of a friend or relative to the pay roll may seem negligible. The same is true of increases in salaries, payments for traveling or entertainment expenses, wastes of materials, and other such items. In the aggregate, the increases in expenses may be important.

The large company is often handicapped by the acquisition of high-cost factories. Some of the plants taken into the new company may be poorly located as regards such factors as markets, sources of raw materials, and labor supply. Some plants may be equipped with obsolete machinery. A combination cannot be

strong if it is made up of weak units or if it contains several weak units.

If the stock of the large company is held in small lots by a great many persons, other elements of weakness may arise. The paid manager often lacks a personal interest in the company.

The large company may be no more fully integrated than the smaller one. To secure the benefits of large-scale production, it is not necessary that all the producing units in an industry be brought together under a single control. On the contrary, many relatively small companies are fully as well integrated as the larger companies. This fact is illustrated by the degree of integration achieved by the Bethlehem Steel Corporation. Although this company is less than one-third as large as the United States Steel Corporation, it is almost as well integrated. Its business includes the following:

1. Manufacturing steel, iron, and certain other products, including structural shapes, rails and rail accessories, plates, sheet piling, bars, rods, blooms, billets, slabs, sheet and tin plate bars, skelp, pipe, tubes, strip, tin plate, wire and wire products, bolts, spikes, car wheels, railroad switches, armor plate, axles, brass castings, pig iron, machinery, coke, and by-products of coke.

2. The construction of steel passenger-train, freight-train, and mine cars.

3. The fabricating and erecting of steel bridges, buildings, tanks, and miscellaneous structures.

4. The building of naval and merchant vessels.

5. The mining and quarrying of ore, coal, and limestone.

6. Transporting of ore and other products on the Great Lakes and on the high seas.

7. The operation of short-line railroads.

8. The operation of public water-supply systems in the vicinity of certain plants.

9. The operation of warehouses for the distribution of products manufactured by subsidiaries.

10. Ownership of houses for rental to employees.

Some companies manufacture large numbers of products of which the management may not have intimate knowledge. When one company makes a wide variety of products which are not

closely related, it may be questioned whether one person or one small group of persons can efficiently manage all of its activities. The Federal Trade Commission, in the report prepared for the Temporary National Economic Committee, lists 127 products of one large company in the chemical and related industries. It mentions another company which operates the following: businesses producing numerous breakfast cereals, animal feeds, gelatine, ice cream mixtures, a medley of desserts; a coffee and tea business; a cake and bread business; a chocolate and cocoa business; a coconut-meat business; a sirup business; a nut business; a salt business; a baking-powder business; a business of manufacturing laundry aids; an oyster business; a business of processing frosted foods; a business of processing corn products; a business of canning fruits and vegetables; a business manufacturing cottons and shipping cases and bags; a business of manufacturing tin cans; and a business of meat packing.[13] The Commission questions that the managers of this company can efficiently administer such an enterprise.

Many economies of large-scale production can be effected only within the single plant. To a large extent, the efficiency in mass production is achieved within a plant by the effective coördination of men, machines, and materials. These economies include, for example, the use of highly specialized machines for the manufacture of a single product, the elimination of costs and expenses due to adjustment of machines for different manufacturing processes or products, and specialization of executives and workers in various tasks. When several large and well-organized plants are brought under the control of a single management, the possibilities for further economies may be limited.[14] Other costs and expenses may also appear, which offset any economies.

Many directors do not devote sufficient time to their duties. Directors may at times neglect corporate affairs because they have accepted too many positions of responsibility. For example, the Federal Trade Commission found that the 19 directors of the American Telephone and Telegraph Company held 172 other business affiliations.[15] One director held positions in 29 other enterprises and another in 25. This appears to be typical of both large and

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[13] T.N.E.C. Monograph No. 13, p. 119.

[14] See statement prepared by Frank A. Fetter in T.N.E.C. Monograph No. 13, pp. 398-415.

[15] *Ibid.*, p. 120.

medium-sized companies. The Commission believes that multiple directorships impair business efficiency and that the complexity of the affairs of one company requires the undivided attention of its managers. Many persons holding directorships on several corporations actually leave the responsibilities of management to the officers and to other members of the board. This is indicated by the fact that the average attendance at board meetings is low and that most of the directors who attend regularly are also officers of the company.[16]

Questions

1. To what extent is American industry characterized by large-scale production? To what extent is it characterized by monopoly?
2. Is monopoly always undesirable? Why?
3. What is duopoly? Is it as objectionable as monopoly?
4. Distinguish horizontal, vertical, and complementary combinations.
5. What advantages may the large combination have in purchasing? In manufacturing? In selling? In finance? In general administration?
6. Does a monopolist have the advantages of large-scale production as well as the advantages of a monopolist?
7. How would a monopolist know where to set his price?
8. What advantages to the government and to the country generally may result from large size?
9. What tests of efficiency might be employed in measuring the advantages or disadvantages of size?
10. Why must the results of statistical studies of profits of large and small companies be accepted with some reservation?
11. What do the studies of large and small companies indicate as to their relative efficiency?
12. What four propositions were stated by the National Industrial Conference Board as the results of its study of the relation of size to efficiency?
13. What conclusions do you draw from the study which the Federal Trade Commission made for the Temporary National Economic Committee?
14. Can the results of the various studies referred to in the text be reconciled?
15. What wastes in operations may accompany increase in size?
16. May a company become too large for efficient management?

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[16] R. A. Gordon: *Business Leadership in the Large Corporation,* p. 132. Brookings Institution, Washington, 1945.

17. Why would management permit a business to increase in size to the point where it becomes less efficient?

18. What economies may be best achieved in the individual plant? Are further economies to be achieved by the combination of a number of plants to form one large company?

19. Is efficiency affected by multiple directorships?

PART FIVE

Regulation of Combinations

CHAPTER XXVIII

Common-Law Regulation of Business Combination

Of the legal or social devices for controlling business combination, the common law was the first to develop. The common law is that body of legal principles which has been built up through court decisions and legal precedent, not by legislation. Early common law, as it related to business combinations, was defective in several respects; but it did prohibit many competitive practices, and it was not without its effect upon business organization. As business enterprise developed and various forms of combination were devised, however, the common law proved itself wholly unable either to prevent the formation of gigantic combinations or to protect the interests of the small businessman and the consuming public. Beginning about 1890, therefore, it was found necessary to enact statutes dealing with business combinations.

I. The Development of Common-Law Regulation

The common law relating to business practices was developed in England during the latter part of the Middle Ages and the early part of the Modern Era. It grew up in a simple economy which was devoted largely to agricultural and household production and naturally was adapted to meet the needs of the business organization of that time. During the Middle Ages most of the trading was conducted at annual fairs; business relationships were thus relatively easy to regulate because trading was limited to certain places and to certain times in the year. Moreover, most people produced their own food and clothes, and combinations and monopoly did not affect the people as vitally as they would today. Nevertheless, it was recognized at a very early period that monopoly was harmful to society.

Conspiracy to raise the price of food was very early considered a crime. Among certain of the early Germanic tribes there was an established custom that every transaction involving the sale of food had to take place in the presence of witnesses. The purpose was not only to prove the facts of the sale but also to offer assurance that the buyer should not pay too high a price for the article purchased. A fear that sellers would charge unreasonable prices for food and provisions was extant very early in England, and legal measures were developed to regulate trade and to insure competition. The attempts to monopolize goods in the markets were classed as forestalling, engrossing, and regrating. These were not separate offenses, but often were only different aspects of the single offense of interfering with free trade and attempting to raise prices. The laws against these offenses were at first a part of the common law, but statutes were later passed prohibiting them.

Forestalling was the buying of goods before they reached the market. Forestalling included the buying of grain in the sheaf before it was winnowed, the purchase of fish before the boats reached shore, and the buying of any provisions which were being sent to the market. It was one of the very earliest offenses to be recognized by the English common law, and was considered objectionable not only because it restricted the freedom of the market, but also because it caused the owner of the market to lose the rent which would be charged for stallage, and the town to lose the tolls that outsiders were required to pay.

Engrossing was the buying of merchandise with the intention of selling it again. The objection to engrossing was that if a trader were to be permitted to buy "in gross" and to sell again, he would expect to make a profit from the transaction, and if the merchandise passed through several hands, the price would be increased before it reached the ultimate consumer. Moreover, it was feared that some persons might be able to buy the entire market supply of a commodity and to sell it at whatever price they chose. The possibility of a corner on a commodity was, in fact, considered so serious that it was made an offense to buy with the intent to sell again regardless of whether or not any part of the supply was actually re-sold. A merchant who brought merchandise into the kingdom was permitted to sell "in gross," but the person who bought from him was not permitted to sell again.

Regrating was buying and selling in the same market. Regrating at first seemed to signify buying "by the great" and selling "by

the retail," but one of the very early statutes defined it as buying grain, fish, or meat in any fair or market and selling it in the same place or within four miles thereof.

Forestalling, engrossing, and regrating were offenses for which the offender could be indicted at common law.

The early English common law against forestalling, engrossing, and regrating has been reflected in the American attitude toward combination. The American colonists brought with them the policy enunciated in the early common law and the later statutes, but there is some question as to whether at American common law the offenses were indictable. Actually, the effect of the English law is to be found in the American attitude toward combination and in the statutes of the various states and of the Federal government prohibiting it.

II. Agreements to Restrain Trade

An agreement to restrain trade is an agreement which does not relate to prices directly but which results in the elimination of competition between two or more persons. For example, if *A* and *B*, competitors, should sell their businesses to corporation *C*, or if *A* should sell his business to *B* with an agreement not to enter the same line of business in the United States during the rest of his life, there would be a restraint of trade without an agreement to raise prices. The result might be a decrease in output or an increase in prices; yet the original contract was an agreement in restraint of trade. Many agreements in restraint of trade are, of course, coupled with agreements to raise prices.

Agreements to restrain trade are not enforceable at common law. An agreement by any person not to compete with another is void in that it cannot be enforced. One of the very early cases in which this rule was sustained was the famous dyer's case, decided in 1415 during the reign of Henry V. A dyer had violated an agreement not to practice his trade in a certain town for a period of six months. In a suit to recover damages, it was held that the agreement was contrary to public policy and not enforceable. The objection which the court had to the agreement was not that the public was deprived of the dyer's services so much as that he might be prevented from making a living and thereby become a public charge. In time, however, the fear that agreements of this sort might lead to a reduction in the supply of the commodity or service

involved became the controlling factor in the attitude of the courts.

Grants of monopoly by the Crown were held not to be enforceable. In 1602, an English court declared illegal a specific grant of monopoly by the Queen as contrary to the common law and to divers acts of Parliament. The court held that monopolies were opposed to the public interest because they tended to increase prices, to deteriorate the quality of commodities, and to reduce artificers to idleness and beggary.[1] The common law did not, however, have the force to prevent the continuation of Crown grants of monopoly, and they were finally abolished by the Statute of Monopolies in 1624.

The common-law opposition to combinations in restraint of trade assisted in the breakdown of the exclusive privileges of the guilds. Thus, in 1690 a cloth worker was accused by a guild of exercising his trade without having served the required period of apprenticeship; but without a specific repudiation of the legality of the guild regulations, it was held that the worker was not really practicing the trade but that the merchant who supplied the materials was the one exercising the trade. The worker was held not to be subject to the regulations of the guild.[2] In such wise was the last barrier to free competition removed.

The fact that the agreements in restraint of trade were void means that they could not be enforced. If all of the parties to the agreement abided by it, the law simply did nothing about it. Furthermore, if the combination adopted measures to harass others in the attempt to force them out of business, the competitor against whom the practices were directed had no legal ground for action against the conspirators. The position of the courts is illustrated by the Mogul Steamship Company Case decided by the English House of Lords in 1892. A number of ship-owners, who had been transporting tea from Hankow, China, entered into a combination to ruin the business of an outsider who had entered the shipping business at Hankow and was lowering prices. They agreed to an aggressive campaign against his ships, and each time that he scheduled a ship from Hankow, the companies entered one to sail at the same time. The independent ship-owner sued for damages for his losses, but he was held not entitled to damages. The com-

[1] Darcy *v.* Allen, 11 Coke 84. A digest of British and American decisions on monopoly, illegal combination, and restraint of trade may be found in the Congressional Record, Feb. 6, 1903, pp. 1857-1866.

[2] National Industrial Conference Board: *Mergers in Industry*, p. 9. New York, 1929.

bination was not illegal to the extent of affording grounds for action to anyone injured by it.

An agreement which only incidentally restrained trade could be enforced at common law. In the age of Queen Elizabeth, all restraints of trade were thought to be contrary to public policy and therefore void. It was found, however, that a rigid rule of this sort interfered with transactions of everyday occurrence, since the sale of any business to another might be held to result in a restraint of trade. Gradually it came to be recognized that partial restraints of trade might be socially desirable. In time, the principle was established that an agreement which had the restraint of trade for its primary purpose was void; but if the purpose of the agreement was legal and the restraint of trade was only an incidental consequence, the agreement was valid and could be enforced. Contracts which in some measure restrain trade but which are nevertheless valid are as follows: [3]

1. *An agreement made by a person selling a business that he will not again engage in the same business for a period of years.* This is simply an agreement to protect the value of the goodwill of the business which has been sold. Such agreements are valid provided they are reasonable, extending only for the time during which the goodwill of the old business may be expected to continue and covering only the territory over which the goodwill of the old business extended. The time and the territory included in the agreement vary with the nature of the business. For example, a contract not to engage in the motion-picture business in a certain town was enforceable even though it was unlimited as to time,[4] and a filling-station lease containing an agreement by the lessor not to engage in a competitive business for five years was also held valid.[5] The restraint of trade which resulted from these contracts was considered incidental to a legitimate contract of sale.

2. *An agreement made by a retiring partner not to compete with the business he has just left.* When a partner retires from a business, he sells his interest in it, and an agreement which he makes is similar to one made by a person who sells an entire business. This kind of agreement is therefore similar to the agreement that has

[3] W. H. Taft: *The Anti-Trust Act and the Supreme Court,* pp. 8-10. Harper and Brothers, New York, 1914.

[4] Clay *v.* Richardson, 290 S.W. 235 (Texas, 1926).

[5] Star Refining Co. *v.* Butcher, 84 S.W. (2d) 303 (Texas, 1935).

just been discussed, and the reasonableness of the restraint of trade involved is to be decided on the same grounds.

3. *An agreement by a partner entering a business not to do anything to injure it by competition or otherwise.* An agreement of this kind may result in depriving the public of the services of a partner, but the other partners have a right to expect that each partner will do what he can to further the interests of the partnership.

4. *An agreement made by a person in buying a piece of property not to use it in competition with the business of the seller.* The common-law courts saw no danger to the public in contracts of this nature, for the owner of the property could either keep it or sell it on his own terms. If he kept it, he could restrict the use to which it was put; and if he sold it, he had the same privilege. Since there is always other property which can be used in competition with the business of the seller, the contract does not constitute a threat of monopoly.

5. *An agreement by a person entering the employ of another not to compete with the employer after the termination of the period of service.* The purpose of this agreement is to protect the employer from loss due to the use by the employee of confidential information or special technical training gained from the business of the employer.[6]

At first the position of the courts was that if the consideration for any of the five contracts just enumerated adequately compensated the person for the restraint upon his liberty of action, the contract was legal. In time, however, the courts ceased to inquire whether the compensation was adequate but looked only to the primary purpose of the contract. If the purpose was to effect a valid sale or other contract and the resulting restraint of trade was only incidental, the contract was valid. If the purpose was to hinder others and not to promote trade, it was considered to be contrary to public policy and therefore void. This point is important in view of the later decision of the United States Supreme Court—that the Sherman Act declared illegal only those combinations which constituted unreasonable restraints of trade.

Agreements to control prices were void at common law. The courts very early held that such agreements were illegal at common law because they were contrary to public policy. This meant

[6] Texas Ice and Cold Storage Co. *v.* McGoldrick, 284 S.W. 615 (Texas, 1926).

simply that the court would not lend its aid to any of the parties to such agreements; it left the conspirators where it found them. For example, about the year 1875 all of the grain dealers in a town in Illinois agreed to control the price of grain and to divide the profits of the grain trade of the town among themselves. Shortly after the agreement was made, one of the parties died and his son asked for an accounting of the profits. The agreement was considered by the court to be an attempt to create a monopoly and to raise prices, and for this reason it was illegal. Since the contract was void, the court refused to aid either party.[7] The view of the courts that contracts made to foster a monopoly or to control prices are void has been reaffirmed many times.

The common law was ineffective against combinations to raise prices. Positive action against the conspirators was very unusual, and for the most part the common-law courts were content with a policy of non-interference. Yet a mere refusal to enforce contracts or agreements to maintain or to raise prices was not enough to protect the interests of the public, for in the vast majority of cases the parties to the agreement had everything to gain by living up to it. It is no criticism of the courts to say that they were ineffective, for they were not equipped to seek out the guilty parties and bring them before the bar of justice.

Corporations which entered into combinations to restrain trade or to control prices were subject to a forfeiture of their charters. In an earlier chapter it was shown that the trusts were dissolved under the common law. The principal ground for the decisions dissolving the trusts was that the corporations had exceeded their authority under their charters in entering the trust which was a partnership. The courts also referred to the fact that the trust agreements tended to establish monopolies and that monopolies were opposed to the public interest. This attitude was clearly indicated by the decisions against the Sugar Trust in 1890[8] and the Oil Trust in 1892.[9] In each case it was held that the action of the stockholders in turning over their stock to the trustees constituted an act of the corporation which was contrary to public policy, justifying the forfeiture of the charter of the corporation which had participated in it.

The fact that corporate charters were subject to forfeiture if used

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[7] Craft *v.* McConoughy, 79 Ill. 346 (1875).

[8] People *v.* North River Sugar Refining Co., 121 N.Y. 582.

[9] State *v.* Standard Oil Co. of Ohio, 49 Ohio 137.

in furtherance of monopoly was of little effect in preventing combinations. The reasons were that: (1) new methods of forming combinations were devised when some forms were declared illegal; (2) the suit for the forfeiture of the charter had to be brought by the state which had granted it. Therefore, if a corporation had its charter forfeited in one state, it was a simple matter for it to obtain another charter in some other state which followed a more liberal policy.

III. Unfair Competitive Practices

The relation of competitive practices to the problem of industrial combination is that the growth of many combinations may be traced in part to the use of unfair practices which were destructive of actual or potential competition. Once a business has acquired a predominating position in an industry by taking unfair advantage of its competitors, it may be able to maintain its position by destroying local competition wherever it appears.

The inability of the common law to meet the problem of unfair competitive practices is well known. It must not be assumed, however, that the common law permitted each trader to do as he pleased without restraint or liability. On the contrary, definite and real penalties were provided, inadequate though they were.

Some competitive practices constituted grounds for suits for damage at common law. While for the most part the policy of the common-law courts was a negative one of non-interference, this was not so when a producer or trader was injured by an encroachment upon his personal rights by a competitor. Specifically, the competitive practices which were illegal and which gave rise to suits for damage at common law were as follows:

1. *Infringement of the trade name or trademarks of another.* The right to the use of a trade name or a trademark is secured by using the name or the trademark upon a product offered for sale. The right is acquired when the name becomes associated, in the mind of the consumer, with the product of a certain business. For another to use the same trademark would result in the diversion to him of business which was intended for the original user of the trademark, and the wrong resulting from infringement consisted not only in taking business from another but also in working a deception upon the consumer. The businessman whose trade name or

trademark had been infringed upon had a valid claim for damage against the guilty person, and it was no defense to say that the infringement was unintentional. Proof of the absence of illegal intent would perhaps help to reduce the amount of damages levied against the offender, but he would in any case be required to differentiate his product so that the consumer would not be deceived.

2. *Misappropriation of trade secrets.* The crime here consisted in appropriating to one's own use secret processes of manufacture or secret formulæ of another, which were acquired through confidence. A person who acquired such a secret while in the employ of another and who was guilty of a breach of confidence was personally liable. If the misappropriation of trade secrets was accomplished as a result of espionage rather than a breach of confidence, there was no relief at common law.

3. *Malicious interference with the business operations of another.* This offense sometimes consisted of false statements about the character or professional ability of a competitor. Sometimes it was a deliberate disparagement of the products of a competitor that implied dishonesty or fraud. The legal regulations originally adopted by the courts for the protection of the name of a natural person engaged in business were later extended to corporations, which also were protected against malicious attack.

Interference with the operations of a business which took more direct forms was sometimes ground for claims in damages. This was true, for example, of spying upon the salesmen of competitors and interfering with their dealings with customers, and also of inducing the public to make unreasonable demands upon a competitor for service or other accommodations. These practices were illegal when their object was to injure a competitor rather than to build up the trade of the person who was responsible for them.

Trade practices which injured the public generally did not give cause for action. The practices mentioned in the preceding paragraphs were directed against some one competitor, and the injury inflicted upon him constituted valid grounds for a suit for damages. However, if no one competitor could establish his claim that he had suffered injury, no valid claim for damages arose. Therefore, if a practice was intended to stamp out all competition and to discourage new producers from entering the field, no one would be able to establish a right to damages although the injury to society might be very real. The injury consisted, first, in the loss to the

public from having to pay higher prices for the products that it purchased and perhaps in some cases from having to buy an inferior product; and, second, in the loss to individuals who would have entered the business thus controlled but who were afraid to enter because of the competitive practices of an established producer.

Among the practices that injured the public but for which the common law offered no relief, was railroad discrimination. When the railroads granted low freight rates to a producer, he had an advantage over all others which in some cases enabled him to drive out all competition. He could do this when the freight charge was a substantial percentage of the total cost, as it was for heavy and bulky commodities like oil and coal. Another practice which was legal was misbranding. If, for example, a manufacturer advertised his washboards as being made of aluminum or his clothing as being made of wool, when in fact the composition was entirely different, the common law offered no relief. The operation of a subsidiary company as an independent company, and failure to disclose that it was part of a large combination, was not an offense at common law, though clearly the public might be injured by it and small competitors crushed.

The use of fighting brands was legal at common law. This practice consisted of the use of a brand of merchandise on which prices might be cut when competition appeared in any quarter, the brand being taken off the market when the competition had been driven out. A practice very similar to the use of fighting brands was local price-cutting. Here, instead of reducing the price of one kind of merchandise while holding up the prices of others, the manufacturer reduced the price of the product in one locality while it was maintained or increased elsewhere. In each instance competition was difficult because the price war of the large competitor was subsidized by the profits made on other products or on the same product in another locality.

IV. Inadequacy of the Common Law

The common law was defective in several respects. It had to be supplemented by statute because it was unable to cope with the problems presented by modern business with its large-scale production and its national and world-wide markets. The deficiencies of

1. *Agreements to restrain trade were not illegal.* Agreements in restraint of trade might be destructive of competition and work great injury upon individual businesses, but so long as the members of the combination were willing to abide by the agreement, there was no way to protect the interests of the public.

2. *The common law was not adequately equipped to prevent combinations to raise prices or to punish the conspirators.* The common-law courts did not have effective administrative machinery for discovering conspiracies to raise prices and for bringing the guilty parties into court.

3. *Many competitive practices that were destructive of competition and injurious to the public interests were legal.* Unless some one competitor could trace his loss to a definite practice, no cause for action arose, and practices that were directed against all competitors and all potential competition were legal. As such practices in many instances led to combination and monopoly, their regulation was a necessary part of state and Federal antitrust legislation.

The public in time began to realize the weaknesses of the common law, and the legislature of the several states and the Federal government took steps to remedy them. There was necessarily a period of experimentation, and many years elapsed before effective regulation was established.

Questions

1. When, where, and how was the common law developed?

2. Distinguish engrossing, regrating, and forestalling.

3. What is the difference between an agreement to restrain trade and an agreement to raise prices?

4. What is meant by the statement that agreements in restraint of trade were illegal at common law?

5. Were the grants of monopoly by Queen Elizabeth socially desirable? Are grants of monopoly ever socially desirable?

6. Under what circumstances would a member of a conspiracy in restraint of trade desire aid in enforcing a contract?

7. What is an agreement which incidentally restrains trade? Is it the same as a reasonable restraint of trade?

8. Name the types of agreements which might incidentally restrain trade and indicate why each is socially desirable.

9. What was the penalty at common law for becoming a member of

a conspiracy in restraint of trade? What was the penalty against corporations?

10. What is an unfair competitive practice? Give examples.

11. What competitive practices were illegal at common law? In what sense were they illegal?

12. What types of competitive practices were legal at common law? Give examples.

13. Why was the common law inadequate to deal with the problem of combinations in restraint of trade?

14. Why was the common law inadequate to deal with the problem of competitive practices?

CHAPTER XXIX

State Antitrust Legislation

Despite the weaknesses of the common law in dealing with combinations in restraint of trade, there was no general attempt to strengthen it until about 1889. In that year a number of states passed legislation dealing with the subject, and in 1890 the Federal government passed its first antitrust act. The reason for the interest in the problem at the time was that an investigation by the legislature of New York had made public many of the facts relative to the trust movement. Industrial combinations prior to 1880 had largely taken the form of gentlemen's agreements and pools, and the public was not yet greatly concerned about the problem. But during the decade ending in 1890 when the various trusts were formed, the opposition to industrial combinations began to be crystallized.

I. The History of State Antitrust Legislation

State and Federal antitrust legislation during the early nineties did not represent a new conviction on the part of the legislatures and the people. It was pointed out in connection with the history of the corporation that the early attitude of the American colonies and the states was one of opposition to monopoly. This attitude dates at least from the days of Queen Elizabeth, when exclusive trading privileges were given to various court favorites and to joint stock companies.

The hostility toward corporations gradually disappeared after 1800, and by 1850 most states had passed laws which were favorable to corporate development. That monopolies were still considered objectionable, however, was demonstrated on numerous occasions. The ease with which Andrew Jackson was reëlected President in 1832 when opposed to the renewal of the charter of the Second Bank of the United States by associating the bank with monopoly control of money, is evidence of this fact. At a later period, popu-

lar feeling on the issue of free silver was aroused by the allegation that special interests were monopolizing the supply of money. This attitude is partly responsible for the fact that the United States has twelve Federal Reserve Banks instead of one central bank.

Several states prohibited industrial combinations during the period 1889 to 1895. The first state law was that of Kansas, enacted in 1889. Ten other states and territories later in the same year enacted legislation or amended their constitutions to prohibit combinations and monopolies. By 1893 about half of the states and territories had made either statutory or constitutional prohibitions of combinations and monopolies.[1]

Several states passed antitrust laws from 1895 to 1900. The combination movement received a check with the crisis and panic of 1893 and with it the movement for the regulation of combinations. Beginning in 1895, and particularly with the return of prosperity in 1897 and 1898, several additional states passed antitrust laws. Among the states entering the lists against industrial combinations at this time were New York, Illinois, Indiana, and Wisconsin. By 1900 more than thirty states had prohibited combinations and monopolies.[2]

Additional legislation was passed during the years 1910 to 1914. The third period of antitrust legislation was marked not only by the enactment of legislation by states which previously had not taken action, but also by the revision of legislation in other states to make the laws conform to prevailing ideas. The idea embodied in the Federal antitrust legislation of 1914 was that combination should be regulated and that certain unfair practices which enabled one corporation to drive out another should be prohibited. Consequently, a number of states prohibit price discrimination between localities or customers, and certain other practices.

At the present time, all but seven states have either statutory or constitutional prohibitions, namely Delaware, Nevada, New Jersey, Oregon, Pennsylvania, Rhode Island, and West Virginia. Oregon is included in the list because its law prohibits only discrimination in the receiving and purchasing of milk, cream, and butter fat. In Rhode Island a statute apparently is considered unnecessary be-

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[1] Ernst von Halle: *Trusts or Industrial Combinations in the United States,* pp. 17–18. The Macmillan Co., New York, 1900. See also Seager and Gulick: *Trust and Corporation Problems,* p. 342. Harper and Brothers, New York, 1929.

[2] House Committee on Judiciary, Report 1501, 56th Cong., 10th Sess., May 15, 1900.

cause combinations and conspiracies affecting the public may be indicted under the common law.

In 1933 a movement to suspend the antitrust laws was begun in many states. The reason for the suspension of the state antitrust laws was the situation that was created by the enactment of the National Industrial Recovery Act. This Act permitted trade associations to draw up codes of fair competition for their industries and granted exemption from the Federal antitrust laws to all agreements drawn up in conformity with the Act. Since many of the codes contained provisions which might be held to violate the antitrust laws of the states, an attempt was made to obtain legislation to remove the uncertainty and to permit the full operation of the Recovery Act. Thus, New York state passed a law in August, 1933, which provided that any code of fair competition or trade agreement which was approved by the President of the United States should be exempt from the provisions of the antitrust law of the state, so long as the National Industrial Recovery Act was in force. It provided also that any code or agreement, when approved by the President, would become New York state law and would be binding upon all businesses in that state.

All of these laws became inoperative when the National Industrial Recovery Act was declared unconstitutional in 1935. However, some of the state laws were held to be unconstitutional even prior to the invalidation of the Federal Act. The reason for their unconstitutionality was that they involved an illegal and unauthorized delegation of legislative functions on the part of the state legislatures. The law of any state must be enacted by its legislature and not by Congress or a Federal administrative agency.[3]

In recent years many states have enacted special price legislation. The state laws relating to price are of two kinds. One type of law permits the manufacturer to fix the retail price of his product or to prescribe a minimum retail price by contract with the wholesaler or the retailer, the contract being binding upon subsequent retailers or others who resell the product. It is not necessary that subsequent dealers be parties to the contract; all that is necessary is that they be aware of the existence of the prescribed retail price. This is the most common type of price legislation. The other type prohibits the sale of merchandise below cost. This legislation is in effect a partial abandonment of the theory that competition should

[3] Darweger *v.* Staats, 267 N.Y. Supp. 290 (April, 1935).

be maintained throughout the economic system and is therefore a partial relaxation of the state antitrust laws.

II. The Provisions of the State Laws

As might be expected, the provisions of the state antitrust laws show many variations in their details. Essentially, however, many of them are very much alike. All of them prohibit certain types of combination; many of them, though not all, attempt to define the types of combination which are prohibited. All of them provide for penalties, though the penalties differ greatly. Notably the wording of many of the early state antitrust laws followed the wording of the Sherman Act. Later legislation frequently contains provisions which show that parts of the Clayton Act of 1914 have been adapted to the state law.

Many state constitutions now prohibit combinations. The state of Maryland is content with a constitutional declaration that "monopolies are odious, contrary to the spirit of a free government, and ought not to be suffered." The Arkansas constitution contains a similar clause, but Arkansas also has enforcement legislation. Most of the state constitutions which have prohibitions of monopoly direct the legislature to pass appropriate legislation. The Kentucky constitution states that "it shall be the duty of the general assembly from time to time, as necessity may require, to enact such laws as may be necessary to prevent all trusts, pools, combinations, or other organizations" from combining to depreciate the price of any article below its real value, or to enhance the price above its real value. A slightly different provision is found in the Alabama constitution, which says:

> The legislature shall provide by law for the regulation, prohibition, or reasonable restraint of common carriers, partnerships, associations, trusts, monopolies, and combinations of capital, so as to prevent them or any of them from increasing unreasonably the cost thereof to the consumer, or preventing reasonable competition in any calling, trade or business.

The Arizona constitution confidently declares that "monopolies and trusts shall never be allowed in this state," and directs the legislatures to pass whatever legislation is necessary for the enforcement of the provision, and to provide adequate penalties.

Various types of combination are prohibited by state legislation. One state may prohibit "trusts," another "monopolies," another

"pools," and another "trusts, pools and monopolies," but in fact the definitions given in these statutes indicate that the states are merely calling the same thing by different names. The Arkansas statute, for example, states that "a monopoly is any union or combination or consolidation or affiliation of capital, credit, property, assets, trade, customs, skill or acts or any valuable thing or possession, by or between persons, firms, or corporations whereby any one of the purposes or objects mentioned in this act is accomplished or sought to be accomplished."

A trust, according to the Nebraska law, is "a combination of capital, skill or acts, by any person or persons to fix the price of any article" or to restrict competition in any other way. A similar definition of a trust is found in the statutes of several other states, among them Florida, Ohio, and Mississippi. The Mississippi law includes engrossing and forestalling among the objects of a trust, but does not define the terms. The North Dakota law uses the words "pool" and "trust" as synonymous and gives them a definition similar to that quoted from the Nebraska statute.

While the particular methods of combination which are prohibited vary with the state, the definitions are sufficiently broad to cover all forms of combinations. The state laws, in fact, seem to leave little choice as to the form of organization, for all are condemned if the object is to increase prices or restrict production.

Many states prohibit unfair competitive practices. Most of the laws prohibiting unfair methods of competition have been enacted since 1912. The campaign discussions of that year had served to emphasize the belief that the growth of combinations might be prevented if competition could be made fair. Some of the practices prohibited are:

1. *Local price discrimination in selling.* This is the practice which is most frequently condemned. The Minnesota law prohibits local price discrimination in "any commodity in general use," and this is the provision in several other states. Many states prohibit price discrimination in "any commodity." Differences in prices are permitted where they are due to differences in grade, quality or quantity, or differences in cost due to transportation or other expenses. Nebraska prohibits selling at less than fair market value or at a lower price than the vendor is accustomed to demanding and receiving in any other place.

2. *Local price discrimination in buying.* Most of the states

which prohibit local price discrimination in selling prohibit also local price discrimination in purchasing. In most states the prohibition extends to all articles. Thus the Iowa law provides that any person, firm, or corporation that discriminates between different sections or localities by purchasing at higher prices in one section than in another shall be guilty of unfair competition, provided the purpose has been to destroy the business of a competitor or to create a monopoly. As in local price discrimination in selling, allowance is made for differences in grade or quality, or in cost of transportation. Mississippi specifies that a company owning a number of cotton gins in different sections of the state may not discriminate in the prices paid for cotton seed or prices charged for ginning services.

3. *Railway discrimination.* Discrimination by railway companies in favor of certain large shippers was a common practice prior to 1903, but has now been virtually stopped, so far as interstate commerce is concerned, by Federal legislation. Nevertheless, Nebraska, Idaho, and some other states prohibit it. The person receiving the rebate is made liable as well as the railway company.

4. *Exclusive dealer arrangements.* North Carolina prohibits any business from making a sale on condition that the purchaser shall not deal in the merchandise of a competitor.

5. *Wilfully injuring a competitor's business.* A few statutes state that any individual or business that wilfully injures or attempts to injure the business of a competitor is guilty of violating the law.

6. *Boycotting.* The Missouri statute declares that any person who becomes a member of any pool, trust, agreement, or other combination to limit competition, and who boycotts or threatens any person to prevent him from buying or selling to any other person who is not a member of the combination, shall be deemed guilty of a conspiracy in restraint of trade.

The above list is illustrative of the practices condemned by the antitrust laws of the various states. It is not exhaustive, but it does include all of the practices usually mentioned. Many of the states, however, make no attempt to prevent unfair methods of competition. Among the states which have the most comprehensive statutes are North Carolina, Mississippi, Nebraska, and Idaho.

Adequate penalties are provided. The penalties to be levied

against corporations or individuals entering into combinations to restrict prices or limit production vary greatly. Virtually all of the states that have legislation provide for the forfeiture of the charter by a domestic corporation, and ousting of a foreign corporation from the state, in addition to a fine. Several states make individuals liable to imprisonment in the county jail for a term not exceeding one year, in addition to the payment of a fine.

Idaho, Missouri, Maine, and several other states follow the Federal Antitrust Act of 1890 in permitting any person who is injured by a combination to raise prices or to restrict competition, to recover damages equal to three times the amount of the loss. Mississippi provides that the injured party may recover the amount of damages sustained and $500, regardless of whether the action was "inimical to public welfare."

Some states make the officers of the corporation liable. Some states make the directors and officers who are responsible for the violation of the law, liable to fine and imprisonment, while other states make them liable for the debts of the corporation. Thus, the North Dakota law makes them liable to a fine not to exceed $2,000 or imprisonment in the county jail not to exceed one year, or to both the fine and imprisonment. Illinois and Idaho have similar provisions. In Nebraska any officer or agent who violates the law, or who votes for or consents to the violation of the law, becomes liable for all the debts and obligations of the corporation. Liability for a fine seems to be a more just penalty than is liability for the debts of the corporation.

III. Evaluation of State Antitrust Legislation

State legislation has been of very little effect in preventing the growth of large combinations or in breaking them up. In most states little attempt has been made to enforce the law, and in states which have been active the results have not been very satisfactory. The three states which have been most aggressive are Missouri, Texas, and Illinois. Illinois brought a number of suits under the law prior to 1900, but since that time has gradually become less active in its attempts at enforcement. Missouri and Texas have kept up the prosecutions under their laws and are still among the most active. Even those states, however, were unable to dissolve the big combinations or to put them out of the state. The most that the states have been able to do has been to levy fines against

some of the combinations and to oust a few of the smaller companies and a few subsidiaries of large corporations.[4]

Only the state from which a corporation holds its charter can dissolve it. The Federal government may order the dissolution of a corporation if it has violated Federal law, but the states cannot do so. The state which granted the charter can require the corporation to surrender it if the corporation has violated the laws of that state. But so long as a few states have liberal corporation laws and no antitrust laws, corporations can obtain their charters from those states and have no fear of dissolution proceedings from any state. As in other matters pertaining to corporations, the most liberal state sets the pace for the rest.

Ousting a corporation from the state is not an adequate solution of the problem. In some lines of manufacture there are only two or three large corporations. If one of these is put out of the state, the principal result may be to turn the market of the state over to the one or two remaining producers. If all of the producers in one line of production have combined to restrict competition, and if all of them are ousted, there may not be anyone to supply the market. The public thus may be injured more than the ousted corporations. Moreover, production may be economical only if a large market is available, and a single state may not be able to offer a sufficiently large market. The prices charged by a monopolistic combination may be lower than those of an independent company operating on a relatively small scale. In a line of manufacture which requires specialized machinery and a large capital investment, an independent producer would be afraid to set up a factory for fear that the large producers would circumvent the law through a secretly controlled subsidiary, and there is always the possibility that an ouster decision may be reversed.

Fining the corporation is not an adequate remedy. This may help to relieve the state finances, but it does not correct the difficulty. The objection to monopoly or to combinations in restraint of trade is that certain alleged social evils result, such as high prices to consumers, low prices to the producers of raw materials, losses to small businesses which are compelled to sell out to the combination, the closing of the opportunity to enter business, and the like. What

[4] See Seager and Gulick: *Op. cit.*, pp. 351-366, for an excellent discussion of the experience of Texas and Missouri in enforcing their antitrust laws. A valuable collection of cases on all phases of trade regulation is S. C. Oppenheim: *Cases on Trade Regulation.* West Publishing Co., St. Paul, 1936.

is desired is the prevention of combination and the maintenance of competition. Fines do not result in the dissolution of the offending corporation or the separation of any of its subsidiary corporations from it.

The machinery for enforcement is inadequate. The enforcement of the law is left with the Attorney General, and whether he is aggressive or not depends largely upon his political aspirations and the state of public opinion. If he wishes to do so, in some states he may receive a great deal of publicity by an active policy of opposition to big combinations. However, if he neglects to enforce the law, he is not likely to be criticized, because the public is not informed of industrial conditions and competitive practices within the state. What is lacking is a fact-finding body to gather and disseminate information in order that the public may demand and support enforcement activities by the offices of the Attorney General.

The problem of industrial combination is essentially a national problem. The big consolidations of today are not confined within state lines but are nation-wide. Therefore the Federal government is the logical organization to decide whether they are to be encouraged, regulated, or dissolved, and to take whatever action is necessary to accomplish the purpose. The gathering and dissemination of information pertaining to industrial problems can be accomplished most economically and most effectively by a central organization rather than by the individual state. If it is found that an industrial corporation has combined with its competitors or bought out their businesses, action should be taken by the Federal government in the interests of all the states, rather than by each state acting separately in its own interests.

Questions

1. What was the first state to pass antitrust legislation? When?
2. What were the reasons for the enactment of antitrust legislation about 1890?
3. What new provision was included in antitrust legislation in 1913 and 1914? Why was such a provision included at that time?
4. Why were the antitrust laws suspended in many states after 1933?
5. Does a law prohibiting sales below cost have the same purpose as antitrust legislation? Does it conflict in purpose with the antitrust laws?
6. Why should a provision be included in a state constitution pro-

hibiting combinations in restraint of trade? Is such a prohibition likely to be effective?

7. What types of combinations are prohibited by state antitrust laws?

8. What competitive practices are prohibited by antitrust laws?

9. What are the penalties for violation of the antitrust laws?

10. Have the state antitrust laws been effective? Why or why not?

CHAPTER XXX

Federal Antitrust Legislation to 1903

The Federal government has enacted a number of laws dealing with industrial combinations. Of these the best known are the Sherman Act of 1890, the Clayton Act of 1914, and the Federal Trade Commission Act of 1914. A complete discussion of the Federal antitrust legislation and its enforcement will not be attempted, first, because it would not be possible within the limits of the present study; and second, because a detailed discussion would probably be more confusing than helpful. Since the Sherman Antitrust Act was enacted, several hundred suits under it have been instituted. Not all of these are important for our purposes, however; and only a few of them need to be discussed.

I. The Sherman Antitrust Act

Although the states were busily engaged about 1890 in passing laws against pools, combinations, and trusts, it was felt even at that time that the problem of combinations in restraint of trade was essentially national. The states had not yet made a serious attempt to enforce their laws, and many persons believed that the problem could best be handled by the Federal government. Under its constitutional power to regulate interstate commerce, therefore, Congress undertook to pass legislation dealing with the problem. The Antitrust Act of 1890 was one of the most important laws ever passed, and has probably been the subject of more litigation than any other law ever enacted by Congress.

The law declared all combinations in restraint of trade to be illegal. The provisions of the law were most sweeping. It declared illegal "every contract, combination in the form of trust or otherwise, or conspiracy in restraint of trade or commerce among the several states, or with foreign nations." The penalty for making such contracts or entering into such combinations was a fine not exceeding $5,000, or imprisonment not exceeding one year, or both.

It was declared a misdemeanor for any person to "monopolize or attempt to monopolize, or combine or conspire with any person or persons, to monopolize any part of the trade or commerce among the several states, or with foreign nations."

The two clauses just referred to contain the substance of the law. The remaining clauses were merely administrative, conferring jurisdiction of cases arising under the Act upon the Federal courts, authorizing the district attorneys and the Attorney General to prosecute cases of violation, and providing for the summoning of witnesses. One very important provision was that any person who was injured by any other person by reason of anything forbidden under the Act should be entitled to recover threefold the damages sustained and the costs of the suit. In all, the Act covered only a little more than two pages of ordinary size. But volumes have been written and much controversy has been waged over the question of what really was meant.

The difficulty in determining the meaning of the law has centered principally around the meaning of a contract or combination "in restraint of trade." The law declared every contract in restraint of trade illegal, but it made no attempt to define restraint of trade. Now almost every combination at least partially restrains trade. If two or three taxicab drivers operating across state lines combine, they have eliminated competition between themselves and have restrained interstate trade. Literally, the law would seem to prohibit all types of combinations in so far as they are concerned with interstate commerce.

On the other hand, it was argued that since the law related to combinations in trade and not to combinations in manufacture, the Act could be applied to combinations in trade and commerce only. If this view had prevailed, the law would have been entirely without application to industrial combinations. Congress has no constitutional power to regulate manufacturing, and necessarily restricted the application of the law to trade and commerce between the states. Thus, while the provisions were stated in the most sweeping terms, the application of the Act was subject to different interpretations.

II. Enforcement of the Sherman Act

After the Sherman Act was passed, the combination movement continued with little legal restraint. The Oil Trust was dissolved

but a community of interest was established in the industry. The Sugar Trust was changed to a consolidated company, and the Cotton Oil Trust was changed to a holding company. Pools in the steel and other industries were a matter of common knowledge.

The government failed in an attempt to apply the Sherman Act to industrial combinations in 1895. This was the famous case against the American Sugar Refining Company. Officially it is known as the Knight case[1] because suit was brought against the E. C. Knight Company, which had recently been acquired by the refining company. It will be recalled that the American Sugar Refining Company had been organized in 1890 as an amalgamated company to take over the sugar refineries of the old Sugar Trust. The company had gradually acquired most of the existing refineries. By 1892 it had acquired all but five sugar refineries in the United States. Four of these were in Philadelphia, the E. C. Knight Company being the largest. When the Sugar Refining Company acquired the four Philadelphia refineries in 1892, it increased its control of sugar production to 98 per cent. In January, 1893, the government filed suit to cancel the sale of the Knight Company to the combination.

The Sherman Act was held not to apply to a monopoly of manufacture. The court admitted that a virtual monopoly in the refining of sugar had been created, but it drew a distinction between a monopoly of manufacture and a combination in restraint of trade. The business of sugar refining was manufacturing, not commerce, and the purchase of sugar refineries that gave a control over manufacturing did not constitute a restraint of trade. The mere fact that the sugar later entered the channels of trade, it was argued, was not enough to cause the refining of sugar or the acquisition of sugar refineries to be classed as commerce. If the Federal government had power to regulate all contracts and combinations in manufacturing, agriculture, and mining whose ultimate result is external commerce, there would be little of business operations and affairs left for state control.

To understand the logic of this reasoning, it is necessary to go back to the precedent upon which it was based. Some years earlier the state of Iowa had passed a law forbidding the manufacture of alcoholic beverages, whether for sale within the state or for export to other states. The prohibition of the export of alcoholic bever-

[1] United States *v.* E. C. Knight Company, 156 U.S. 1.

ages seemed to be a regulation of interstate commerce over which the states had no power, but the United States Supreme Court had declared that the Act was a regulation of manufacture, not commerce.[2] This reasoning, applied to the case of the E. C. Knight Company, seemed to indicate that the Sherman Act had not been violated by the sale of manufacturing plants to the combination.

The Knight case was generally interpreted as nullifying the Sherman Act. This was the first decision to be rendered by the Supreme Court in interpretation of the Sherman Act. It was generally accepted as expressing the views of the court in future cases to come before it, and it seemed to open the way to the combination of competing companies without any restriction. If the purchase of refineries was not commerce, then neither was the purchase of the stock of a competing corporation. There appeared to be no legal prohibition against any combination from obtaining complete control of other important commodities such as oil, cotton, flour, and meat. This was the view taken by industrial leaders who entered the era of combination in 1898 and later years in full confidence that they were in no danger from prosecution under the Sherman Act.

The Federal administration also believed that the Knight case proved the government to have no power to prevent or to dissolve industrial combinations and monopolies. In his next annual report, rendered in December, 1895, the Attorney General declared that combinations and monopolies could not be reached under the Sherman Act merely because they were combinations and monopolies, nor because they engage in interstate commerce as one of the incidents of their business. President Cleveland declared that because of the complexities of our political system, the Federal government was powerless to control industrial combinations in an effective manner. The only possible means of control, he said, was legislation by the states.

The decision of the court in the Knight case has not been over-

[2] Kidd *v.* Pearson, 128 U.S. 1 (1888). In that case the court said: "Manufacture is transformation—the fashioning of raw materials into a change of form for use. The functions of commerce are different. The buying and selling and the transportation incident thereto constitute commerce. . . . If it be held that the term includes the regulation of all such manufactures as are intended to be the subject of commercial transactions in the future, it is impossible to deny that it would also include all productive industries that contemplate the same thing. The result would be that Congress would be invested, to the exclusion of the states, with the power to regulate, not only manufactures, but also agriculture, horticulture, stock raising, domestic fisheries, mining—in short, every branch of industry."

ruled, but the doctrine has been gradually circumscribed until it no longer has any application. While the court might say that if precisely the same circumstances were presented to it, the decision would be the same, there is no possibility that another case exactly the same in all its details will be presented.

The government succeeded in applying the law to railway pools. The Supreme Court handed down two decisions declaring railway pools to be in violation of the Sherman Act, one in 1897 and the other in 1898. The first of these, known as the Trans-Missouri Freight Association case,[3] was a suit against the railroads operating west of the Missouri River which had joined in an agreement to maintain freight rates. The railroads offered two defenses: (1) that the railroads were not subject to the Sherman Act but were regulated solely by the Interstate Commerce Act of 1887, and (2) that the Sherman Act did not prohibit all combinations in restraint of trade but only agreements which unreasonably restrained trade. The railway agreement, they said, was not an unreasonable restraint of trade.

Both points were decided against the railroads. In answer to the first contention, it was pointed out that the Act included "every contract, combination in the form of trust or otherwise" and that since the railways were not made specifically exempt from the law, the Act must have been intended to apply to them. Moreover, the court reaffirmed the decision in the Knight case and stated that under that decision combinations in manufacture were not subject to the Act. It then made the astonishing statement that "to exclude agreements as to rates by competing railroads would leave little for the Act to take effect upon."[4]

In answer to the argument that the law prohibited only agreements unreasonably restraining trade, it was said that according to its wording, any restraint of trade or commerce was illegal. The court declared that it had no authority to read the word "unreasonable" into the law, that this would amount to legislation by the court, and that if any modification of the law was to be made, the relief would have to come from Congress and not by a process of judicial legislation which was wholly unjustifiable. There was a strong dissenting opinion on this point by a minority of the court.

The second decision applying the Antitrust Act to the railroads,

[3] United States *v.* Trans-Missouri Freight Association, 166 U.S. 290 (1897).

[4] 166 U.S. 313.

known as the Joint Traffic Association case,[5] involved an agreement of thirty-one railroads in the territory between Chicago and the Atlantic coast. The roads had agreed upon freight rates and a division of traffic throughout the territory. The contentions of the roads were much the same as in the Trans-Missouri case, with the additional argument that the Sherman Act was unconstitutional because it violated the right of freedom of contract. This last argument was easily disposed of, since many regulations of business involve some encroachments upon the freedom of contract. The right to freedom of contract could not be held to justify highway robbery, for example, even though the participants were bound to each other by contract. Moreover, many kinds of contracts not bad in themselves may be prohibited by legislation of the states or Congress. The decision ultimately rested therefore upon the question of whether the Sherman Act was a legitimate exercise of the power of Congress over interstate commerce. Since Congress had the power to regulate interstate commerce, the Act was valid as an exercise of that power.

In 1899 the government succeeded in applying the Sherman Act to industrial pooling agreements. The first industrial combination to be dissolved as a result of a decision of the Supreme Court was the Addyston Pipe Pool. The decision in this case [6] was the second one involving an industrial combination. The Addyston Pipe Pool was a combination of manufacturers of cast-iron pipe for the purpose of dividing markets, increasing prices, and, in some sections of the country, sharing profits through a system of bonuses.

The defense of the members of the pool was based upon three arguments: (1) The regulation of private contracts of individuals by Congress represented an unwarranted invasion of the rights of the states and an interference with the rights of the individual. (2) The pooling agreement did not come within the scope of the Sherman Act, because it had no bearing upon interstate commerce. (3) The prices charged by the pool were reasonable.

The first argument was similar to that offered in defense of the joint traffic association. The real defense of the pool was its reliance upon the Knight case, and the significance of the decision is in this same contention. The decision in the Knight case was expressly reaffirmed, but the Addyston Pipe Pool was contrasted with the sugar combination. The court pointed out that the sugar com-

[5] United States *v.* Joint Traffic Association, 171 U.S. 505 (1898).

[6] Addyston Pipe and Steel Company *v.* United States, 175 U.S. 211 (1899).

bination had acquired the title to property, whereas the pipe pool was a combination definitely intended to control prices and sales in interstate commerce. The pipe combination directly restrained not alone the manufacture but also the purchase and sale of the manufactured commodity. Thus, the consolidated company was held to be legal even though it controlled a large percentage of the producing capacity of the country; whereas the pool was held to be illegal. The Addyston Pipe case when contrasted with the Knight case seemed to prove that the consolidated company had a favored position under the law.

In answer to the argument that the prices charged by the pool were reasonable, it was declared by the court that the issue was unimportant. The significance of the agreement was that it gave "the defendants the power to charge unreasonable prices had they chosen to do so." It was not within the power or responsibility of the courts to consider the question of the reasonableness of the prices charged.

Early experience under the Sherman Act seemed to indicate that it was ineffective against industrial combinations. The successes of the Sherman Act were restricted to: (1) pooling agreements of industrial corporations; and (2) pooling agreements of the railways. Thus, of the various forms of combination found in industry, only pools had been held to be illegal. It was difficult to enforce the law against pools because most pools were secret. Moreover, if pooling agreements were illegal, it was an easy matter to adopt some other form of combination. The one attempt to dissolve a consolidated company had ended in the defeat of the government, and no attempt had been made to dissolve a holding company. No suit against a trust under the Sherman Act was ever carried to the Supreme Court, since the trust form had been proved to be illegal under the common law and was obsolescent before the enforcement of the Sherman Act got under way.

III. Strengthening the Antitrust Act

The necessity for strengthening the position of the government in the antitrust suits was apparent as soon as the decision in the Knight case was given, but no immediate attempt was made to pass additional legislation or to secure a constitutional amendment. It was not until 1898 that any action was taken by Congress. In that year it created an Industrial Commission, composed principally of

its own members, for the study of industrial problems. It investigated several of the trusts, made a compilation of the state laws relating to industrial combinations, and made a study of the problem in Europe.

An attempt to amend the Constitution was made. In 1900 it was proposed by the majority party in the House of Representatives that the Constitution be amended to give Congress the power to regulate manufacture. The purpose was to correct the threatening situation created by the decision in the Knight case, which permitted manufacture to be monopolized with impunity. The amendment was opposed by the minority party largely on the ground that no serious attempt had yet been made by the government to enforce the law. It was argued that if the powers of the states to deal with the problem were to be curtailed by a constitutional amendment and the Federal government continued to be negligent about enforcement, there would be no curb upon industrial combinations. The reduction of the tariff was urged as a more effective measure. The attempt to amend the Constitution and the attempt to modify the Sherman Act both failed.

The Bureau of Corporations was created in 1903 to investigate industrial combinations In that year a Department of Commerce and Labor was established, and the Bureau of Corporations was one of the divisions of the new department. It had no power to regulate corporations in respect to either their unfair practices or their agreements restraining trade. It had power only to investigate corporations and to make public the facts.

The Bureau undertook extensive investigations of a number of corporations and industries in which combinations were believed to exist in violation of the law. The most important of the reports were those dealing with the beef, petroleum, steel, tobacco, and harvesting-machine industries. The reports, made public from time to time during the life of the Bureau from 1903 to 1915, were of great value in aiding the Department of Justice in bringing prosecution and in securing an enlightened public opinion. Their value in forcing a change in corporate practices, however, was negligible.

Discriminations in railway rates were prohibited by the Elkins Act of 1903. This did not represent an amendment to the Antitrust Act but was another way of attacking the problem of industrial combination. Large shippers had been able to force the railways to grant concessions in railway rates, and many persons believed that

3. What is the basis of the argument that only unreasonable restraints of trade were prohibited?

4. What was the issue in the Knight case? On what ground did the court hold that the American Sugar Refining Company had not violated the law?

5. What was the effect of the Knight decision?

6. State the facts, the questions at issue, and the decision of the court in the railway pooling cases.

7. How did the Addyston Pipe Company case differ from the facts in the Knight case?

8. Why is the Sherman Act referred to as the antitrust law when no case involving a trust was decided by the Supreme Court?

9. What was done to correct the situation created by the decision in the Knight case?

10. What was the Bureau of Corporations expected to accomplish? Did it succeed in its purpose?

11. What did the Elkins Act provide? Why was a variation from the published rates made illegal? Why was the person who accepted a rebate liable to fine? Would not anyone accept a rebate if it was offered to him?

CHAPTER XXXI

Enforcement of Federal Antitrust Legislation, 1903 to 1913

The new policy of President Roosevelt began to be effective in 1904, and from that time until the close of his administration in 1909, he carried on an active campaign against large corporations. When his term of office expired, he was succeeded by Taft whom he had actively supported for nomination and election. While Taft was not as aggressive as Roosevelt had been and he did not please the former president, he did prosecute a great many cases and with notable success. An aggressive policy was therefore continued until the beginning of the First World War.

Of the decisions rendered during the years 1903 to 1913, four were outstanding victories for the government. These were: (1) the dissolution of the Northern Securities Company, (2) the prosecution of the meat packers, (3) the dissolution of the Standard Oil Company, and (4) the dissolution of the American Tobacco Company.

I. Dissolution of the Northern Securities Company

Until 1904 it had been the general belief that a holding company was not subject to the Sherman Act, regardless of the percentage of output of an industry which might be controlled. The principal basis for this belief was the decision in the Knight case. The idea was partially dispelled in 1904 when the Supreme Court ordered the dissolution of the Northern Securities Company, a railway holding company.

The Northern Securities Company was organized to combine the Great Northern and the Northern Pacific railroads. The main lines of these two roads extend from Minneapolis across the Northwest to Portland and Seattle, Washington. Throughout much of the territory their lines are parallel. Early in 1901 the two roads, anxious to get an entrance into Chicago, had jointly acquired the Chicago, Burlington, and Quincy Railroad. The Northern Securi-

ties Company was formed to take over the stock of the Great Northern and the Northern Pacific, thus combining the three roads. It was incorporated in New Jersey with a holding-company charter. It exchanged its stock for the stock of the two railroad companies. Suit under the Sherman Act was instituted in 1902.

Many arguments were advanced in defense of the company. It was argued: first, that the company had been organized as an investment company and that its purpose was not restraint of trade. Second, it was contended that transfer of property was not a violation of the Sherman Act and that the company was not a railroad company. Third, it was said that the company was authorized by the state of New Jersey to acquire the stocks of railway companies. Fourth, it was argued that the company had not suppressed competition but had actually reduced rates. The principal reliance was the contention that the acquisition of securities was not commerce.

The Supreme Court decided against the company on every argument. In answer to the argument that the purpose of the company was investment, the court said that the company was not the real purchaser of the stocks but only the custodian for the benefit of its own security holders. The argument that the company had not engaged in interstate commerce was answered by the statement that a corporation which controlled the railway service in a large section of the country could restrain interstate commerce. In answering the contention that the state of New Jersey had legally granted the corporate charter, it was said that "no state can by creating a corporation or in any other mode, project its authority into other states, and across the continent, so as to prevent Congress from asserting the power it possesses under the constitution." Moreover, a state cannot exempt a corporation engaged in interstate commerce from obedience to any rule lawfully established by Congress.

The fourth argument that the company had not suppressed competition, was answered with the declaration that "the mere existence of such a combination and the powers acquired by the holding company as its trustee constitute a menace to and a restraint upon the freedom of commerce." The dissolution of the company was ordered in one of the famous five-to-four decisions.[1]

The enforced dissolution of the company was of far-reaching importance. With the decision in the Northern Securities case in

[1] 193 U.S. 197.

favor of the government, a long step had been taken in overcoming the effects of the Knight decision. In fact, if the lawyers for the company had succeeded in establishing their contention that the Sherman Act did not apply to the holding company, there would have been no Federal control over combinations, and it would have been a simple matter to build up complete monopolies by the holding-company method. The overthrow of the Northern Securities Company has been said to constitute "the most positive achievement of the Roosevelt administration in the field of corporation finance." [2]

In an earlier chapter it was pointed out that after this decision the consolidated company was considered to hold a better legal position than the holding company. The Knight case had not been reversed, but the doctrine had been held not to apply to holding companies. Doubts therefore began to be expressed about the legality of many other holding companies. While only one company had been dissolved, a precedent had been established which might have far-reaching effects.

II. Prosecution of the Packers

Although the government had dissolved the Northern Securities Company, this was, after all, another application of the law to the railways. Until the law was applied to a manufacturing company, the effects of the Knight case could not be said to have been definitely overcome. A further step in this direction was accomplished in 1905 when the government succeeded in obtaining an injunction against the packers, ordering them to refrain from certain practices.

The meat-packing industry was largely in the control of a few companies. Even as early as 1900, the economies from the concentration of meat packing in large establishments had resulted in the growth of large plants at a few cities, principally Chicago, Kansas City, East St. Louis, South Omaha, and St. Joseph. Each one of these companies controlled a number of subsidiary corporations varying from three to twenty-four. The National Packing Company, the third largest company, had been organized in 1902 by three other large companies: Swift and Company, Armour and Company, and Nelson, Morris and Company. It had acquired

[2] A. D. Noyes: *Forty Years of American Finance*, p. 349. G. P. Putnam's Sons, New York, 1909.

plants at several cities, including East St. Louis, Omaha, and Kansas City, in addition to several stockyards and a sales organization for dressed meats. In several cities the six companies had acquired a complete control of the business of meat packing, though there were a few small independent packing plants in some cities.

The government charged that the packers had eliminated competition. It was alleged by the government that the large companies had agreed not to compete with each other in the livestock markets, and that they had agreed to bid up the prices of stock for a few days to induce cattlemen to send their stock to those cities and to reduce the price when large shipments began to arrive. It was further charged that the packing companies conspired to fix the prices at which they would sell, and to that end to restrict shipments of meat when necessary. They had established uniform credit terms and kept a blacklist. They had obtained rebates from the railways in defiance of the law and with intent to monopolize the commerce among the states.

The packing companies alleged that the transactions at the stockyards were not a matter of interstate commerce. Relying once more upon the doctrine of the Knight case, they contended that the case of the government rested upon the charge of illegality of certain acts done at the stockyards, but that such transactions were not prohibited by the Sherman Act because they had nothing to do with commerce between the states. They declared that the slaughter of animals, and the dressing of meats was not interstate commerce, and that the acts complained of were still further removed from commerce because they preceded the process of meat packing.

The restriction of interstate commerce at any point was held to violate the law. The Supreme Court held that interstate commerce included all phases of the transaction from the original shipment through the purchase of the animals, their slaughter, the dressing of the meats, and the shipment of the meat, to the end of the transit in another state. The restriction of the purchase and sale of the animals therefore constituted a restraint upon interstate commerce.[3]

While affirming the decision in the Knight case, the Supreme Court held that the facts in the packers' case were sufficiently different to result in a decision against the companies. In contrasting the two cases, the court said:

[3] United States *v.* Swift and Company, 196 U.S. 375 (1905).

Here the subject matter is sales and the very point of the combination is to restrain and monopolize commerce among the states in respect of such sales. The two cases are near to each other, as sooner or later must happen where lines are to be drawn, but the line between them is distinct.

Although the court found a difference between the Knight case and the packers' case, the decision in the earlier case would probably have been different if the court had placed the same interpretation upon the meaning of interstate commerce. A monopoly of the manufacture of sugar does constitute a restraint of trade, for interstate commerce in sugar includes the shipment of raw sugar to the refinery, its manufacture, and its further shipment to another state. Thus, the decision in the packers' case greatly limited the scope of the doctrine of the Knight case. The inference was that if another case of precisely the same circumstances as the Knight case were to be presented, the decision would be the same, but the court was distinguishing new cases from it in such a manner that it was, in fact, taking a new view of the situation.

III. Dissolution of the Standard Oil Company

The crowning achievement of the campaign for the enforcement of the Sherman Act which had been initiated by President Roosevelt was the dissolution of the Standard Oil Company, ordered on May 15, 1911,[4] followed later in the same month by a decision ordering the dissolution of the American Tobacco Company. These two corporations were among the largest and oldest of the big combinations, and they had done more than any other two corporations to arouse the opposition of the legislatures and the public. In the decisions of May, 1911, the government had finally overcome the effects of the Knight case. Hereafter it would not be considered a precedent.

The Standard Oil Company had monopolized the oil industry since 1879. Much of the history of the Standard Oil Company has been recited in preceding chapters, but will be briefly reviewed here. The first Standard Oil Company was incorporated in the state of Ohio in 1870, just eleven years after the drilling of the first oil well in the United States at Titusville, Pennsylvania. The rapid rise of the Rockefeller interests has usually been attributed to the ruthless methods employed, though no doubt the ability of the management was also an important factor. From 1870 to 1879 the com-

[4] Standard Oil Co. *v.* United States, 221 U.S. 1 (1911).

pany was able to force many of its competitors to sell their refineries to it, this being accomplished in large part by an alliance with the railways which permitted the company to get rebates on its shipments and which therefore enabled it to undersell its competitors. The pooling agreements in which the company participated were replaced in 1879 by the first Standard Oil Trust and in 1882 by the second Standard Oil Trust. In 1892 the trust agreement was declared void, and it was replaced by the community of interest. The Standard Oil Company of New Jersey, which had amended its charter in 1899 in order that it might take over the stocks of the former trust, had maintained its control of the industry as new fields of production were opened in Kansas, Oklahoma, California, and other states.

The Standard Oil Company had practiced unfair methods of competition. Among the charges of unfair competition made by the government against the Standard Oil Company were the following:

1. The demanding and receiving of rebates, discriminatory rates, and other advantages from the railroads.

2. Monopolization by control of pipe lines and unfair practices against competing pipe lines.

3. Local price cutting at points where necessary to suppress competition.

4. Espionage of the business of competitors.

5. Operation of bogus independent companies.

6. Payment of rebates on oil as a method of price cutting.

The methods of unfair competition were significant in establishing the contention that the company had intended to monopolize the industry. Other evidence was found in the large profits made, and in such practices as the division of the United States into districts, and assignment of each subsidiary to one district in order to eliminate competition between them.

The company was ordered dissolved into 33 corporations. It was held that the transfer of the stocks of the various subsidiary corporations to the holding company in 1899 had been in violation of the law, and the company was ordered to return the stocks to its own stockholders. To make the decree effective, the company was forbidden from "exercising any ownership or exerting any power directly or indirectly in virtue of its apparent title to the stocks of

the subsidiary corporations." The subsidiary corporations were prohibited from paying any dividends to the New Jersey corporation or recognizing its ownership except to the extent that it was necessary to enable that company to transfer the stock.

The rule of reason was announced in the Standard Oil decision. According to the rule of reason, only unreasonable restraints of competition were prohibited by the law. Reasonable restraint of trade was legal. This doctrine had been urged by the defendants in the Freight Association case in 1897 and had been advanced by the minority of the court in its decision at that time. By 1911, as a result of changes in the personnel of the court, the minority had become the majority. The argument in favor of the rule of reason is that every merger or combination of competitors acts as some restraint upon trade, and it is only when the combination includes a preponderant position in an industry or a market that it can be said to be illegal.

The rule of reason has been the subject of much controversy. Justice Holmes rendered a vigorous dissenting opinion at the time of the Standard Oil decision, quoting from the earlier decisions of the court in which it had been held that it would be improper to read the word "unreasonable" into the law. The rule of reason was denounced by the press and by politicians. Outside of the Supreme Court, hardly anyone could be found at the time to defend it except President Taft and Attorney General Wickersham. President Taft contended that in none of the decisions rendered prior to 1911 would the outcome have been different had the court subscribed to the rule of reason.[5] Certainly in all of the cases discussed in this and the preceding chapter, the restraint of trade was unreasonable.

In answer to the criticism that under the law it was impossible for a businessman to determine when he was violating the law, Taft said that if the main purpose of any business arrangement was to reduce competition, and if the reduction of competition was not a mere incidental result, and if except for that purpose the businessman would not enter into the arrangement, the agreement constituted a violation of the law. Mr. Wickersham declared that the difficulty was not in interpreting the law but in getting full, accurate, and reliable statements of the controlling facts.[6]

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[5] William H. Taft: *The Antitrust Act and the Supreme Court*, p. 94. Harper and Brothers, New York, 1914.

[6] Address before New York Bar Association, January 12, 1928.

The greatest significance of the decision of 1911 against the Standard Oil Company appears to lie in the fact that the government had succeeded in dissolving the most powerful combination in the United States. The government had secured a complete change of judicial attitude since the fateful Knight case and had restored vitality to the Sherman Act. As Professor John D. Clark says, it "had succeeded in its critical contest with the greatest of all American trusts and had established what was, in substance, a federal power of life and death over growing industry." [7]

IV. Dissolution of the American Tobacco Company

The second of the great combinations dissolved in May, 1911, the American Tobacco Company, was another most offensive corporation. This company has received only occasional mention in preceding pages. Its importance in the history of American corporations requires that its growth be traced.

The American Tobacco Company was formed as a combination of cigarette manufacturers. Prior to 1890, the tobacco industry was competitive both in the purchase of tobacco leaf and in the manufacture and sale of cigarettes. In that year, five of the big manufacturers of cigarettes consolidated to form the American Tobacco Company, a New Jersey corporation. The authorized capital stock of the company was $25,000,000. In the first year of its operation, it manufactured a little more than 96 per cent of the cigarettes produced in the United States.[8]

The company next secured a large interest in the plug tobacco business. In January, 1891, the company purchased the business of a partnership at Louisville, Kentucky, which had been successfully engaged in the manufacture of plug tobacco. This purchase marked the entry of the company into the plug tobacco business, and from that date until 1898, it rapidly expanded this branch of its business by purchasing the business of other competitors.

The plug business of the American Tobacco Company was not expanded without a struggle. In 1893 the president of the company proposed to the other manufacturers that they consolidate, but the proposal was rejected. Thereupon the company sought to compel the other companies to sell their businesses. It decided to

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[7] *The Federal Trust Policy,* p. 72. Johns Hopkins Press, Baltimore, 1931.

[8] The history of the American Tobacco Company is given in the decision of the court, 221 U.S. 106.

use some of its brands of chewing tobacco in a price war. One of its brands was appropriately named Battle Ax. It cut prices and even gave away large quantities of tobacco as samples. This struggle is known as the "Plug War."

The advantage in the Plug War was with the American Tobacco Company from the start. The reason was that it had a very profitable cigarette business in which it did not have to meet competition. The losses in the plug business, amounting to more than $4,000,000 in the period 1893 to 1898, were met from profits in the cigarette business. By 1898 the company had purchased the business of fifteen tobacco concerns located in eight different states. Other companies decided that it was better for them to come to terms, and in 1898 they joined with the American Tobacco Company in forming the Continental Tobacco Company, a consolidated company with a New Jersey charter which took title to the assets of five large plug manufacturers. The new company controlled about 22 per cent of the plug business of the United States.

The American Tobacco Company also acquired an interest in the smoking-tobacco and snuff business. The original combination in 1890 produced eight per cent of the smoking tobacco of the United States. Its numerous acquisitions immediately after its formation and during the Plug War had increased its output of smoking tobacco until by 1898 it controlled 26 per cent of the output.

In 1900 the American Snuff Company was organized to take over the snuff business of the American Tobacco Company, the Continental Tobacco Company, their subsidiary corporations, and several large independent companies. The American Tobacco Company had a controlling interest in the new company, though it did not own all of the stock. By the end of 1900 the American Tobacco Company controlled the larger part of the snuff business of the country.

The company controlled several related industries. These included licorice, tinfoil, and cloth bags. It failed in its attempt to secure control of the manufacture of cigars, though it did have a large interest in the manufacture of stogies. The reason for its failure to control the cigar branch of the industry was that cigars were made largely by hand. It was easy for new competitors to enter the field as existing factories were bought up. The company entered the retail tobacco business through its acquisition of a controlling interest in the United Cigar Stores Company.

In 1904, after the Northern Securities decision, the various interests of the company were consolidated. A new American Tobacco Company was formed, to which were transferred all of the assets of the old American Tobacco Company, the Continental Tobacco Company, and other subsidiary and affiliated corporations. It was this amalgamated company which was ordered dissolved in 1911. At that time it controlled from two-thirds to five-sixths of the total output of the country in each of the chief branches of the tobacco industry except cigars. Its output of cigars never exceeded one-sixth of the production of the entire country.

The company was held to be a combination in restraint of trade. The Supreme Court found the history of the company replete with unusual and wrongful acts which were prohibited by the law. The company had demonstrated in numerous ways, in the opinion of the court, its purpose to control the tobacco trade. The following facts were evidence of the illegal intent of the corporation:

1. The original combination in 1890 was formed after a fierce trade war.

2. The company had used its power in some branches of the tobacco trade to extend its position there and to expand into other branches.

3. It had attempted to conceal from the public its position in the trade and had sought to evade the law by reorganization.

4. It had purchased plants at large cost in order to close them and to render them useless for purposes of trade.

5. It had required many persons connected with the corporations whose assets were acquired, to contract not to compete with it for long periods of time. The persons who thus obligated themselves included stockholders, officers, and employees of the absorbed companies.

The fact that the corporation was an amalgamated company was held to be immaterial. The company argued that every transaction was a lawful exertion of honest business methods, brought into play for the purpose of advancing trade. In other words, the acquisition of plants and properties of competitors was not illegal as a restraint of commerce. The court said, however, that the Sherman Act prohibited every deed or transaction that came within its prohibitions regardless of the garb in which such deeds were clothed. There was no possibility of frustrating the policy of the

law "by resorting to any disguise or subterfuge of form, since resort to reason rendered it impossible to escape, by any indirection, the prohibitions of the statute."

The company was ordered dissolved. The decision ordering the dissolution of the company was rendered in May, 1911. The plan of dissolution provided that the assets of the company should be distributed among fourteen corporations and that the stocks of these various companies should be issued to the stockholders of the American Tobacco Company. As in the dissolution of the Northern Securities Company and the Standard Oil Company, each stockholder received stocks in every successor company.

The tobacco business was distributed among four companies. One of these was the American Tobacco Company which was being dissolved, the others being Liggett and Myers, P. Lorillard, and R. J. Reynolds. The tinfoil business was distributed between two companies, and the same was done for the licorice business. The snuff business was distributed among three companies. The United Cigar Stores continued to control the retail business, while the stocks of the two companies operating abroad were distributed to the stockholders of the parent company.

The rule of reason was restated. In the case of both the Standard Oil Company and the American Tobacco Company, the introduction of the idea of the rule of reason was immaterial to the decision being rendered, for both companies had unreasonably restrained trade.

The Tobacco Company dissolution represented another great success in law enforcement. Despite the statement of the rule of reason, the government had achieved a great victory. Whereas in 1895 the Act was regarded as a mere gesture from which industrial corporations had nothing to fear, by 1911 it had become something to be feared and respected. The great success of the Taft administration in the oil and tobacco cases has been lost sight of by many persons because of the rule of reason, but a broad survey of the history of the Act reveals the remarkable though belated success which had been achieved.

Questions

1. Why was the Northern Securities Company used as a test case under the Sherman Act? Why was suit not brought against the Standard Oil Company in 1902?

2. What was the defense of the Northern Securities Company? Is a railway a natural monopoly in the same way that an electric utility is a monopoly?

3. Can a state empower a corporation to violate a Federal law?

4. Does large size constitute an offense under the Sherman Act?

5. Why was the decision in the Northern Securities case important?

6. Contrast the decision in the meat-packers case with that in the Knight case. Did the meat-packers case overrule the decision in the Knight case?

7. Did the decision in the packers case end pooling agreements in that industry? Why or why not?

8. How long had the Standard Oil Company monopolized the industry? Did its dissolution undo the wrong it had done?

9. Why were the unfair methods of the Standard Oil Company admitted as evidence against it? Were unfair methods of competition illegal?

10. What was the plan of dissolution in the Standard Oil Company case? What was the weakness of the plan? What other plan was possible?

11. What is the rule of reason? Why was it injected into the decision? Was the Standard Oil Company reasonably restraining trade?

12. Should all restraint of trade be considered illegal?

13. Should the court have the power to read the word unreasonable into the law? What is an unreasonable restraint of trade?

14. Was the victory of the government in the Standard Oil case seriously qualified by the announcement of the rule of reason?

15. How did the organization of the American Tobacco Company differ from that of the Standard Oil Company?

16. What was the significance of the "Plug War"?

17. What is the similarity of the fighting brand to local price cutting?

18. Did the tobacco industry become competitive with the dissolution of the American Tobacco Company?

CHAPTER XXXII

Federal Antitrust Legislation Since 1913

Since 1913 the government has attempted to prevent the growth of large corporations by preventing unfair methods of competition. It was the philosophy of the Woodrow Wilson administration that if a fair competitive field could be maintained, small businesses would have a good chance for survival. This view had already found expression in the Elkins Act of 1903, which prohibited personal discrimination by the railways. The investigations by the Bureau of Corporations and the disclosures before the courts in the beef, oil, tobacco, and other prosecutions had shown that many large combinations had been guilty of using unfair competitive practices.

The Sherman Act had said nothing about unfair practices, though the courts had laid much emphasis upon unfair methods of competition in many of the cases coming before them. To make the prohibitions more definite and to provide machinery for enforcement, two laws were passed in 1914: the Clayton Act and the Federal Trade Commission Act. Although it is difficult to consider these two measures separately, it seems best to defer the consideration of the Federal Trade Commission to a later chapter.

I. The Clayton Act and Later Legislation

The Sherman Act had been a concise statement of a little more than two printed pages in length. The Clayton Act covers about eighteen printed pages. It is a lengthy declaration of principles with numerous enforcement provisions. Many of the clauses are only broad declarations of policy whose practical application is doubtful or uncertain. It contains many provisions not directly related to the problem of industrial combination and has, in fact, been called "a hodge-podge statute."

Two trade practices were declared illegal by the Clayton Act. The first of these was price discrimination between purchasers

where the effect of the discrimination was substantially to lessen competition or to tend to create a monopoly in any line of commerce. This provision was directed principally at local price discrimination which had been an effective method of eliminating competition, particularly in the oil industry. It was provided, however, that differences in price were legal if they were due to differences in grade, quality, or quantity of the commodity sold, or if they were made in good faith to meet competition. The right of any person to select his own customers in bona fide transactions and not in restraint of trade was expressly stated. The mere enumeration of the qualifying provisions indicates the difficulty of the regulation of this method of unfair competition.

The second trade practice that was declared illegal was restrictive sales and leases, generally known as "tying contracts." The sale or leasing of any machinery or other commodities with the stipulation or understanding that the purchaser or lessee should not use the machinery or supplies of a competitor was prohibited, if the effect of the contract was substantially to lessen competition. This provision was directed at such arrangements as that of the United Shoe Machinery Company, which had leased its machines only upon the condition that the lessee agree to use other machines owned by it.

Certain intercorporate stockholdings and interlocking directorates were prohibited. Of the various forms of combination, these two were selected for special prohibition. It was not necessary to prohibit pools and other looser forms of combination, since they were already adequately covered by the law. The interlocking directorates existing in 1913 and the provisions of the law relating to them have already been sufficiently discussed in the chapter on community of interest.

As for intercorporate stockholdings, it was provided that no corporation engaged in commerce should acquire the whole or any part of the stock of another corporation engaged in commerce where the effect would be to lessen competition. Holding companies which were not also operating companies were forbidden to acquire the stock of two or more corporations if the effect of the acquisition would be to lessen competition. The right of a corporation to hold stocks for investment purposes and to organize subsidiary corporations to conduct lawful business was expressly stated.

Since 1914 certain types of business organization have been made exempt from the prohibitions of the Sherman Act. Several

laws have been passed granting certain groups of producers the right to combine. One such law was the Webb Export Trade Act of 1918, which granted corporations the right to combine for purposes of regulating export trade only.

By the Capper-Volstead Act of 1922, agricultural producers were granted the right to combine as coöperative marketing associations. Agricultural and horticultural producers had been granted exemption from the provisions of the antitrust laws by the Clayton Act, provided their association did not have capital stock and was not conducted for profit. The Capper-Volstead Act went further and declared that coöperative marketing associations were legal, provided that no member is allowed more than one vote because of the amount of stock or membership capital he may own, or that the association does not pay dividends on its stock in excess of eight per cent per annum. The association needs to meet only one of these requirements to secure exemption from the provisions of the antitrust laws. The association must, however, deal in the products of members to an amount greater in value than the products handled for non-members.

The Emergency Transportation Act of 1933 granted exemption from the antitrust laws to railway agreements made in pursuance to the provisions of the Act, for the purpose of controlling allowances for the joint use of facilities, avoiding waste, promoting financial reorganization, and other purposes.

II. Attempts at Corporate Dissolution

It was generally believed after the dissolutions of 1911 that many large corporations would soon be dissolved. Attempts at dissolution were made, but they did not meet with the success that had been anticipated. Only one such suit was fully successful, and that was against a proposed combination which had not yet been effected. The result of the attempted dissolutions has been significant in their effect upon corporate organization.

An attempt was made to dissolve the International Harvester Company. The International Harvester Company was formed in 1902 as a consolidation of five leading farm-implement companies. The predecessor companies manufactured virtually all of the farm machinery sold in the Middle West. The important competitors of the new company at the date of its formation produced principally for foreign markets. In 1902 the International Harvester

Company sold eighty to ninety per cent of the farm machinery marketed in the United States. During the next few years, the company gradually expanded its output. It acquired several competitors and also entered related fields of production. It constructed new plants both in the United States and in foreign countries.

In 1914 the company was held to be a combination in restraint of trade. In its complaint the government alleged that the company had acquired a monopoly in agricultural machinery. Although the company was not guilty of offensive competitive practices, was not over-capitalized, and had not made exorbitant profits, the district court held that it controlled such a large percentage of the farm-implement business as to constitute a combination in restraint of trade.[1] It ordered the company to be dissolved into three substantially equal, separate, distinct, and independent corporations, with wholly separate owners and stockholders. This decree was later modified to the extent that any plan of dissolution would be acceptable if competitive conditions were restored and a new situation established in harmony with the law.

A plan of dissolution satisfactory to the government was evolved. The case was appealed to the Supreme Court, and in 1918 the company and the government agreed upon a plan which was accepted by the court. The plan included five parts, which were as follows:[2]

1. The company was not to have more than one representative in any city or town in the United States for the sale of harvesting machines and other agricultural implements.

2. It was to sell to independent manufacturers the lines of machines known under the trade names, *Osborne, Milwaukee,* and *Champion.*

3. It was to sell its factories at Springfield, Ohio, and Auburn, New York.

4. If the three lines and the factories should not be sold within one year after the close of the war, they should be sold at auction at the request of the United States.

5. In any event, if competitive conditions had not been restored by November 2, 1920, the United States should have such relief as was necessary.

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[1] 214 Fed. 987 (1914).

[2] See 10 Fed. (2d) 828 (1926).

The company complied with the provisions of the agreement. But in 1923 the government again brought suit, alleging that the decree of 1918 was inadequate and that despite the fact that the company had complied with it, competitive conditions had not been restored. The three lines which had been sold, it was alleged, were relatively unprofitable and unimportant.[3] It was asked that the company be dissolved into three separate, distinct, and independent corporations.

The courts held that competition had been restored. In 1926 the District Court of Minnesota held that the International Harvester Company was not monopolizing interstate commerce in harvesting machines and that competition was untrammeled. Upon appeal, the Supreme Court agreed that competition had been restored.[4] It said that the three lines of machines which had been sold retained a well-established reputation and a capacity for effective development. The agreement of the company not to have more than one dealer in any town had lost it the services of almost 5,000 dealers. The company was exonerated from any charges of price cutting, price discrimination, or other unfair practices.

The outcome of the International Harvester case was a doubtful victory for the government. Although the company had effected what might be called a partial dissolution, the Department of Justice was not satisfied with the new arrangement; and the results were certainly not comparable with the dissolutions in the oil and tobacco cases. The courts were beginning to take a different attitude which was even more apparent in other decisions.

The attempt to dissolve the American Can Company failed. The American Can Company, another consolidated company, was organized in 1901 with an authorized capital stock of $88,000,000 divided equally into preferred and common. The company issued $78,000,000 of its stock to promoters in payment for ninety-five plants which manufactured about ninety per cent of the tin cans sold in the United States. Many of the circumstances of its organization indicated an intent to monopolize the industry. The factories which the promoters sold to the company had been acquired by them for about $23,000,000 in cash and stock. New plants and new machinery of equal capacity could have been built or purchased for $10,000,000 or less. The former owners were

[3] This was also the conclusion reached by the Federal Trade Commission in its *Report on the High Prices of Farm Implements*, pp. 658-674 (1920).

[4] 274 U.S. 693 (1927).

required to sign agreements not to engage in the can-making business for fifteen years within three thousand miles of Chicago. The new company also acquired patents on can-making machinery, and it made contracts with the principal manufacturers of machinery binding them not to sell machinery to others for a long term of years. During the first year after its organization, the company increased prices; but when it learned that the effect was to induce others to enter the business, it abandoned the policy. About two-thirds of the plants acquired were closed. By the end of twelve years when the government brought suit for its dissolution, however, the company was making no more cans than the aggregate of its competitors. For some years before the suit, the company did not attempt to destroy its competitors, but its methods were fair and its standing was good with competitors as well as customers.

In a decision rendered in 1916, the district court of Maryland held that the company had been organized for the purpose of monopolizing the industry and that its early methods were illegal. Its large size was still a potential instrument for restraint of trade, but the court believed that no public interest would be served by its dissolution so long as it made no attempt to use its power. Instead, the court said that the industry and the customers of the company had benefited in many ways from its organization. It had standardized the sizes of cans. It made good cans which were suited to the needs of its customers. It had spent much money in studying the needs of canners and in improving its products. It had aided canners by making contracts covering their requirements for an entire season, thus assuring them that fruits and vegetables would not spoil because of delay in procuring cans. In many cases, the company stored cans on the premises of its customers at its own expense to assure an unfailing supply. Its prices were both stable and low. The court also emphasized the fact that former conditions could not be restored because many plants had been dismantled. Dissolution of the company, the court concluded, would profit no one but would be injurious to the public interest. The company was so beneficial to its customers and was itself so finely adjusted a machine that the court saw no reason to destroy it.[5]

The American Can Company decision indicated that if a company was efficiently managed, charged moderate prices, and followed fair business practices, the courts would not dissolve it even though it controlled a large percentage of the industry.

[5] United States *v.* American Can Co., 230 Fed. 859, 903 (D.C., Md.).

In 1911 a dissolution suit was brought against the United States Steel Corporation. Although the United States Steel Corporation was formed in 1901, it was not until 1911 that the dissolution suit was brought. Decision was further delayed by the First World War, and the case was not decided until 1920. The government showed that at the time of its organization the company controlled more than half of the iron and steel output of the United States. By 1911 the percentage had decreased by about five per cent. The corporation had participated in numerous pooling agreements and was also largely responsible for the continuation of the Pittsburgh Plus system of pricing. It had greatly expanded its facilities, particularly in the South Chicago area, by the investment of its profits. It had also purchased several properties, the most important being the Tennessee Coal, Iron and Railroad Company at Birmingham, Alabama. The government made the following specific charges against the corporation:

1. That the subsidiary companies of the Steel Corporation, formed during the years 1898 to 1900, were themselves combinations in restraint of trade in their own lines; that they were not the result of normal growth but were artificial combinations formed for the purpose of restraining competition.

2. That in 1901 a super-combination of overwhelming power was formed which unduly restrained competition in all branches of the steel industry.

3. That the corporation had controlled prices and had maintained them at a substantially higher level than had prevailed during competitive periods prior to its formation.

4. That the corporation had a preponderant position in the trade, controlling a large proportion of the total production of ore reserves and of facilities for the transportation of ore.

5. That the purpose of the corporation was not the legitimate development of trade but the suppression of competition and the exploitation of the public. In support of this argument, the government pointed to the large profits made by the company, the large promoter's profits, the gross over-capitalization of the company in anticipation of the excessive profits, and the numerous acquisitions of properties after 1901.

6. That the holding company was merely a method of combining competitors and eliminating competition.

The corporation answered all the arguments of the government. The corporation argued that it had never acquired the power to monopolize the steel industry or to restrain trade, and that it was the result of natural growth. It said also that the acquisition of a preponderant position in the trade does not of itself constitute restraint of trade or monopoly. The interesting argument was made that if power to violate a statue is equivalent to its violation, then all men are guilty, for all have the power to violate not one but many statutes. Finally, it was said that competition had never ceased since the corporation was formed. The testimony of numerous customers was introduced in support of this argument.

The Steel Corporation was found not to be a combination in restraint of trade. By a majority vote of four to three, with two justices not participating, the United States Supreme Court decided in favor of the Steel Corporation.[6] The majority opinion held that the decision was based upon what the corporation had power to do and was doing at the time of the trial, not what it had power to do when organized. The court said that the case of the government was based principally upon the size of the corporation. Size, however, represented merely the power to do evil but was not in itself an evil. The court said that "we must adhere to the law and the law does not make mere size or the existence of unexerted power an offense." It declared that it was unable to see how the public interest would be served by an order for the dissolution of the corporation or the separation from it of some of its subsidiaries. On the other hand, it professed to see a risk of injury to the public interest, including a material disturbance of foreign trade. The public interest was declared to be the paramount regard.

In a vigorous dissenting opinion, the minority declared that the corporation had been organized in plain violation and bold defiance of the provisions of the Sherman Act and that the dismissal of the case "does violence to the policy which the law was intended to enforce, runs counter to the decisions of the court, and necessarily results in a practical nullification of the Act itself."

The decision in favor of the Steel Corporation has been variously interpreted. One opinion is that the Supreme Court has laid

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[6] United States *v.* United States Steel Corporation, 251 U.S. 417 (March 1, 1920). Majority opinion by Justices McKenna, Van Devanter, and Holmes, and Chief Justice White; dissenting opinion by Justices Day, Pitney, and Clarke; not participating, Justices Brandeis and McReynolds.

down a new rule—the rule of business expediency.[7] This interpretation is based upon the concluding statements in the decision in which a fear was expressed that foreign trade might suffer if the corporation were dissolved, and in which the opinion was expressed that "the public interest is of paramount regard."

A second view is that the corporation was not acquitted but merely placed on probation.[8] According to this view the corporation was put on notice that it would have to refrain from unfair trade practices and price-fixing agreements. As a result of the decision, other corporations also are warned that proceedings may be brought against them if their policies are not modified.

A slightly different attitude is that, in view of the vigorous dissenting opinion and the fact that the judgment was rendered by a vote of the minority of the whole court, the decision can be taken as nothing more than a determination of the specific controversy. The statements made by the court, according to this view, are not to be considered as laying down any general rule which would be followed in another case. However, the decision has been used as a precedent in those matters upon which all the justices agreed, namely, that mere size is not an offense and that illegal practices which have been abandoned with no probability of renewal do not render a corporation liable.

In 1926 the formation of a new company to dominate the baking industry was prevented. The fourth attempt at what might be termed a dissolution was successful, but it was a suit against a newly organized company which had not yet taken title to properties. It would in fact be more accurate to say that the government prevented the formation of the combination. The corporation had received its charter but the plans for its organization were not carried into effect.

The company which was formed to dominate the baking industry was the Ward Food Products Corporation. The plan was that the company would acquire the properties or stocks of three large interests, namely, the Ward Baking Corporation, the Continental Baking Corporation, and the General Baking Corporation. The new company was chartered on January 30, 1926, under the laws

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[7] Seager and Gulick: *Trust and Corporation Problems,* p. 261. Harper and Brothers, New York, 1929.

[8] John D. Clark: *The Federal Trust Policy,* p. 197, note 20. The Johns Hopkins Press, Baltimore, 1931.

of Maryland. On February 8, just nine days later, the United States filed a petition against the company and the three corporations whose properties or stocks it was expected to acquire. The government charged that the plan was illegal under the antitrust laws and asked that the companies be enjoined from putting it into effect. On April 3, the court announced a consent decree which granted the relief asked by the government.

No attempt has been made in recent years to dissolve any large corporation. Not only have there been no dissolutions since the Ward case in 1926, but there have been no attempts at dissolution. Two reasons for the failure of the government to bring such suits may be given. First, it was learned through the Harvester, Can, and Steel cases that dissolution is not possible where a company does not completely control an industry and where the company uses fair methods of competition and renders a valuable service to customers and the public. Second, industry has learned that monopolistic control by one company may result in dissolution and that any attempt at such control is hazardous. Consequently, unless the monopolistic position is based upon patents or a control of a raw material, a corporation does not attempt complete control of an industry as the old Standard Oil Company and the former American Tobacco Company did. If competition is eliminated in an industry, it is done through a gentlemen's agreement, possibly effected by a basing-point system of pricing, or through a pooling agreement with competitors, both domestic and foreign. This fact is clearly indicated by the type of complaints filed in the courts by the government. The suits deal with such abuses as agreements in restraint of trade by members of trade associations or by other companies and individuals, boycotting, and misuse of patents. Especially significant are agreements between American corporations and foreign companies or cartels. Much of the activity of the antitrust division is directed toward the exposure and the breaking up of such agreements.

III. Trade Association Activities Under the Antitrust Laws

For a long time, there was much doubt as to what a trade association could do and still be within the antitrust laws. Most of these questions have been clarified by a series of decisions, some in favor of trade associations and some adverse.

The trade association may not engage in any activities which

result in a restriction of competition or an increase in prices. This principle was laid down in a decision involving the American Hardwood Manufacturers' Association in 1921.[9] The manufacturers of hardwood, through their trade association, had exchanged minute details of business transactions and business conditions, including statistics of stocks of goods on hand, production, shipments, and prices. Through letters and reports the members also expressed their views of future market conditions, and these were compiled by an agent of the association and forwarded to all members with suggestions as to future policies. At the meetings of the association, the members discussed price and production policies and worked for a reduction of output and an increase in prices.

While the Hardwood Manufacturers' Association made no definite price agreements, its activities were intended to restrict competition between the members and its reports were used by the members to obtain a general increase in prices regardless of costs or market conditions. Moreover, the trade association, through its officers, had encouraged the members to unite in pressing for higher prices. The system of trade reports immediately exposed the price-cutting tactics of any member, and the possibility of exposure acted as a threat to prevent any reduction in prices. Members who found that other manufacturers were charging higher prices were encouraged to increase their own. Thus, the system of price reporting of the hardwood manufacturers constituted a violation of the law.

Another trade association was found guilty of violation of the Sherman Act in 1923. This was the Linseed Crushers' Council, an association of manufacturers of linseed oil, oil cake, and linseed meal.[10] Twelve corporations, members of the association, had entered into an agreement with the Armstrong Bureau of Related Industries at Chicago for an exchange of information. Each subscriber agreed to furnish a schedule of prices and terms and to adhere closely to the schedule unless he gave immediate notice to the Bureau of a change. Each also agreed, under penalty of fine, to attend a monthly meeting and to report upon matters of interest there to be discussed, to comply with all reasonable requirements of the Bureau, and to divulge no secrets. As a guaranty of good faith, each member was required to deposit security with the Bureau.

This agreement was found to constitute a violation of the law The court said that:

[9] United States *v.* American Column and Lumber Co., 257 U.S. 377 (1921).

[10] United States *v.* American Linseed Co., 262 U.S. 371 (1923).

. . . with intimate knowledge of the affairs of other producers and obligated as stated, but proclaiming themselves competitors, the subscribers went forth to deal with widely separated and unorganized customers necessarily ignorant of true conditions. Obviously they were not bona fide competitors. . . . Their manifest purpose was to defeat the Sherman Act without subjecting themselves to its penalties.

Trade associations may gather and disseminate trade information provided it is not used to restrain trade or increase prices. The plan of the Maple Flooring Manufacturers' Association was found to be legal, although this association was gathering and disseminating among the members much the same kinds of information as that which the Hardwood Manufacturers' Association had supplied its members, including statistics of production, shipments, costs, and prices in actual sales. The difference between the Maple Flooring case and the cases which were decided against the trade associations was that there was no formal or informal agreement among the maple-flooring manufacturers affecting prices, and there was no proof that the activities of the association had affected prices adversely to consumers.[11] On the contrary, much evidence was submitted to show that the trend of prices of maple flooring was in line with prices generally and reflected market conditions rather than artificial control.

In commenting upon the significance of the decision as showing what a trade association might or might not do, the court declared that it decided:

. . . only that trade associations or combinations of persons or corporations which openly and fairly gather and disseminate information as to the cost of their product, the volume of production, the actual price which the product has brought in past transactions, stocks of merchandise on hand, approximate cost of transportation from the principal point of shipment to the points of consumption, . . . and who meet and discuss such information and statistics, without however reaching or attempting to reach any agreement or any concerted action with respect to prices or production or restraining competition, do not thereby engage in unlawful restraint of commerce.

Another trade association whose open price plans were found to be legal was the Cement Manufacturers Association in 1925.[12] The plan of this association resembled that of the Maple Flooring Manufacturers' Association.

[11] Maple Flooring Manufacturers' Association *v.* United States, 268 U.S. 563 (1925).

[12] Cement Manufacturers Association *v.* United States, 268 U.S. 588 (1925).

The open-price plan is illegal if it is combined with agreements not to deviate from the reported prices. The plan of published prices employed by the Sugar Institute was held to be illegal in 1936. The Institute was a trade association with fifteen member companies controlling about eighty per cent of the output of refined sugar in the United States. The members agreed to report their prices to the Institute and to sell only at the prices reported. While there was no general agreement as to what the prices should be and each company was free to fix its own prices, the agreement not to sell except at the posted price and not to give quantity discounts was illegal. Other Institute practices that were illegal included the agreement not to make contracts permitting a buyer to take delivery more than thirty days from date, and the agreement to refuse to deal with any customer who acted as both broker and warehouseman.[13]

A member who participates in illegal activities is liable. After the decisions of the Supreme Court concerning trade-association activities in 1923 and 1925, the liability of a member of a trade association convicted of illegal activities was uncertain. A member might unknowingly participate in a conspiracy in restraint of trade by supplying information which was illegally used by others. At the time he supplied the information he might not know that others were using it for price fixing. The liability of such a person appears to have been determined in 1943 when a Federal court laid down the following principles: [14]

1. If the purposes of an association appear to be lawful, a member who supplies trade data is not liable for illegal use of price or other statistics unless he has reason to believe that the association has ceased to follow its avowed purposes.

2. When a member learns that his association is aiding or engaging in price-fixing or other illegal activities, he must cease to supply trade information to it or to coöperate in any way. A member can usually determine from the kind of information he is asked to submit and from communications from the trade association when the members are improperly using the trade information.

3. Failure of a member to dissociate himself from a group which is engaging in illegal activities amounts to a ratification of what

[13] Sugar Institute *v.* United States, 56 Sup. Ct. 629 (1936).

[14] American Cyanimid and Chemical Corporation *v.* Federal Trade Commission, 139 Fed. (2d) 393 (1943).

it is doing and causes the member to assume joint responsibility for the illegal acts.

The attempt to control "design piracy" was held to violate the antitrust laws. Design piracy is the copying of the design of the product of another manufacturer. The practice has been widespread in many industries but has been especially prevalent in dresses, hats, coats, and other branches of the garment industry. The creator of a design objects to having his creation copied by others because the original loses much of its value to the customer when many copies appear in the market. To correct the practice, trade associations in various industries established registration bureaus where original designs were registered. Members agreed not to copy registered designs and also to deal only with retailers who sold no copies. The Fashion Originators Guild, a trade association of dress manufacturers, employed shoppers in various parts of the country to visit the shops of retailers reported to be selling pirated designs. When a retailer was found to be selling copies, he was ordered to cease doing so under penalty of being refused more dresses from members of the Guild and also of being excluded from the showrooms of members. Any copied dresses in stores of retailers had to be returned to the copyist or "pirate," who was required to accept or be expelled from the Guild. Thus, the plan required the observance of both manufacturer and retailer.

The difficulty which the courts found with the trade-association method of controlling design piracy was that it was intended to give the designer more protection than the law contemplated. Designs can be registered with the patent office and thus protected for a limited period. Designers have found the protection to be inadequate because a slight change in a garment such as the changing of the number of buttons or their spacing makes the design a new one which is not protected by the law. The protection attempted by the trade association through private action, the court held, went beyond that contemplated by Congress and therefore was illegal. The court pointed out that control of the supply of dresses or hats of a certain kind gave the Guild the power to control the price in violation of the law.[15]

Boycotting by a trade association for any purpose is illegal. Trade associations have on several occasions undertaken to control,

[15] Fashion Originators Guild *v.* Federal Trade Commission, 312 U.S. 457 (1941); Millinery Creators Guild *v.* Federal Trade Commission, 312 U.S. 469 (1941).

by boycott, a practice to which they objected, such as sales by a manufacturer to a retailer or a class of retailers. Both the boycott and the exchange of information to make the boycott effective are illegal, and it is not an adequate defense to show that conditions in the industry are being demoralized by the practices of the boycotted person. The combination is unlawful no matter how pressing are the abuses it is designed to correct.[16] A similar agreement by retail department stores to boycott a newspaper which attempted to increase its advertising rates was held to be illegal, and fines were imposed upon the members.[17] A person can choose those with whom he will do business, but he cannot conspire with others to compel a vendor to abandon a practice to which he objects.

IV. Antitrust Enforcement During the War Period

During the prewar and the war periods, the Federal government directed its attention to restraints of trade by agreement between individuals and corporations. Investigation disclosed the existence of a large number of agreements between American and foreign corporations whereby American firms had agreed to refrain from certain lines of manufacture or to limit the production of materials necessary to the defense of the country. Some companies had agreed not to carry on research in certain fields of production. Some of these agreements have been referred to in the chapter on Cartels.

Many pooling and cartel agreements were modified by orders of the courts. Among the more significant of the international cartel agreements condemned by the courts was that between Bausch and Lomb Optical Company and the Zeiss Corporation of Germany. That agreement provided for the division of world markets in military optical instruments between the two companies. Under the terms of the court decree of 1940, the American company is now free to export to any part of the world, and any other American company which wishes to manufacture and sell optical instruments must be licensed by the Bausch and Lomb Company to use its patents, machinery, and technical information upon the payment of a reasonable fee. A similar decree against the Aluminum Company of America in 1942 abrogated an agreement with I. G. Farben

[16] Wholesale Dry Goods Institute *v.* Federal Trade Commission, 139 Fed. (2d) 230 (1943).

[17] S.D., N.Y. (1943). Unreported.

of Germany whereby the Aluminum Company had agreed to limit the production of aluminum and magnesium in the United States. The decree also required the Aluminum Company to license others to use its production patents during the war period without the payment of royalties. After the war, the Aluminum Company will be required to license others to use its patents, but it will be permitted to charge a reasonable royalty fee. In a similar decree involving the Standard Oil Company (N.J.), an agreement with I. G. Farben eliminating competition in the oil and chemical industries was declared unlawful, and the Standard Oil Company was required to license others to use its patents covering the production of synthetic gasoline and synthetic rubber.

The abrogation of restrictive agreements between domestic and alien corporations was very significant. Before the war, production was slowed and the rearming of the country was delayed by the agreements; and while the lost time could not be made up, production in many industries was begun before the situation became critical.

During the war, antitrust enforcement was partially suspended. As in the First World War, it was feared that an active policy of enforcement of the antitrust laws would interfere with the prosecution of the war and also its financing. Moreover, a substantial amount of coöperation in industry was necessary to war production, and such coöperation might be construed to constitute a restraint of trade. Therefore, in April, 1941, the Attorney General announced that acts done by industry in compliance with specific requests by an agency of the government would not be viewed as a violation of the antitrust laws, and that no prosecution would be instituted for acts performed in good faith in coöperation with any agency. Thus, the war agencies became responsible for determining what joint action was essential, although the Attorney General reserved the right to require the discontinuance of any practices believed to be contrary to the public interest.

In October, 1941, it was announced that the formation of production pools by small businesses would not be considered a violation of the antitrust laws, provided the War Production Board and the Smaller War Plants Corporation certified the pool to be necessary. The necessity for such pools arose from the fact that many small companies were unable to make individual contracts but were required to bid on a joint basis. The combined resources of the companies were devoted to the execution of the contract when

it was awarded. Approximately 200 pooling agreements, many of them legally classified as joint ventures, were cleared with the Department of Justice. Immunity from prosecution was granted so long as the activities of the combined companies were limited to collaboration for war production.[18] The pools were subjected to periodic examinations by the antitrust division to determine: first, whether the members used the pool to eliminate competition in their normal business activities; and second, whether the pool members freely admitted others and fairly allocated the work.

An agreement between the Department of Justice and the Departments of War and Navy providing for the postponement of investigations and prosecutions under antitrust laws was announced in March, 1942. The Attorney General agreed to postpone any suit upon certification from the Secretary of War or the Secretary of the Navy that the prosecution would interfere with the war effort. If despite such certification the Attorney General was convinced that prosecution was in the public interest, he could appeal to the President, who would decide whether the case should be prosecuted at once or postponed. Where action was postponed because of the war, suit would be filed as soon as war production would not be affected. At the request of the War and Navy Departments, more than thirty cases were postponed. In 1945 after the end of the war, some of the postponed cases appeared likely to be reopened.

The antitrust laws should be vigorously enforced during the postwar period. The principal restraint upon production both in the United States and in foreign countries has resulted from monopolistic agreements including those between American and foreign corporations. Much has already been done to abrogate such agreements, but many of them are still in effect. In the postwar era, unlimited production will be essential to the meeting of accumulated civilian needs, to the repairing as rapidly as possible of the ravages of war, and to the providing of employment for all persons in need of it. Artificial restraints upon production deny both the goods needed by consumers and the jobs needed by workers. With the greatly increased capacity for production in the United States and the wrecked or damaged industries of many foreign countries, it is doubtful whether cartel agreements dividing world markets, allotting quotas, and limiting production can be successful without the

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[18] Wendell Berge, "Antitrust Enforcement in the War and Postwar Period," *George Washington Law Review*. June. 1944, Vol. 12, pp. 371, 380.

participation of American industry. Thus, the vigorous enforcement of the antitrust laws in the United States is essential not only to American production and trade but also to the raising of the general level of well-being throughout the world.

Questions

1. What trade practices were declared illegal by the Clayton Act?
2. What methods of combination were made illegal? Were all methods of combination in restraint of trade illegal under the Sherman Act?
3. What types of combinations have been made exempt from the antitrust laws? Why have these industries been permitted to be monopolized?
4. Was the International Harvester Company dissolved? Why was is not dissolved into three substantially equal and independent corporations as ordered by the district court?
5. Why was the American Can Company not dissolved?
6. Do the antitrust laws exempt efficient corporations which use fair methods of competition?
7. Is potential competition sufficient to protect the public from monopolistic practices? Is it more important in the can-making industry than in the oil industry?
8. On what grounds did the United States Steel Corporation escape dissolution? What is the basis for the belief that the decision did not represent the opinion of a majority of the Supreme Court?
9. What is the rule of business expediency?
10. What was the significance of the dissolution of the Ward Food Products Corporation? Contrast with the dissolution of the Standard Oil Company.
11. Why have no attempts been made in recent years to dissolve large corporations?
12. When does the dissemination of price information become illegal?
13. How can a member of a trade association know that price information is being used in an illegal manner?
14. What should a member of a trade association do when he learns that price information is being illegally used? What is his liability if he fails to do so?
15. What is design piracy? Is it objectionable from the social point of view?
16. What protection is afforded the creator of designs by the patent laws? Why is the protection considered inadequate?
17. Why was the attempt of trade associations to protect designs illegal?

18. Why is boycotting illegal? Is it socially undesirable?

19. What type of antitrust cases assumed added significance during the war?

20. Why was it considered desirable to postpone some cases until after the war emergency?

21. What types of combination were granted immunity from prosecution under the antitrust laws during the war period?

CHAPTER XXXIII

The Control of Methods of Competition

Methods of competition have played an important part in the growth of many large enterprises in the United States. Some businesses have used fair methods and have grown in size because they were efficient and because they rendered a necessary service or sold a desirable product at a fair price. A few corporations, perhaps a minority, owe at least a part of their success to the use of unfair methods, such as demanding and receiving discriminatory rates for transportation, special concessions from manufacturers of raw materials, bribery of employees of other businesses including competitors and suppliers of materials, intimidation, local price-cutting, misleading advertising, and many other such practices. The prohibition of the use of unfair methods is the result of a belief in fair play and also of a desire to prevent a further development of large-scale industry.

The principal agencies for preventing the use of unfair methods of competition are trade associations and the Federal Trade Commission. The work of trade associations in this field is largely voluntary and depends for its legal sanctions upon coöperation with the Federal Trade Commission and the provisions of the various statutes enforced by the Commission. The most important of the statutes is the Federal Trade Commission Act of 1914.

Unfair methods of competition were made illegal by the Federal Trade Commission Act. The law made no attempt to define the phrase "unfair methods of competition." This would be very difficult to do, for new methods were and still are being devised. No catalogue of them could be complete. If the Federal Trade Commission, which was set up to enforce the Act, believes that a method of competition is unfair, it is authorized to issue a complaint. If it finds the method to constitute a violation of the law, it is authorized to issue an order requiring that the use of the method be discontinued.

Later legislation dealing with unfair methods of competition

has been more specific. In 1938 an amendment to the Federal Trade Commission Act prohibited false advertising of food, drugs, devices for the diagnosis and treatment of disease, and cosmetics. Advertisements of such products must not be misleading; and if the use of the product might be dangerous to health or cause bodily injury when used to excess, the full facts must be stated in the advertisements. This amendment was enacted upon recommendation of the Commission after it had failed to secure conviction, under the provisions of the Federal Trade Commission Act, of a manufacturer of an obesity cure alleged to be dangerous to health.[1] The Wool Products Labeling Act, enacted in 1940, requires correct and informative labeling of all articles of clothing and wearing apparel which contain wool, reprocessed wool, or reused wool. It is directed against failure to disclose the fiber content of clothing or misbranding and irresponsible labeling. This legislation supplements the Federal Trade Commission Act, which applies to all fields of manufacturing and merchandising and to all types of unfair methods of competition.

The power of the Commission is not punitive but preventive. It has no power to levy fines, its direct authority being limited to the issuance of an order "to cease and desist." The purpose is to protect the public; and in protecting the public interests, only an order to cease and desist is permitted or required.

If the person against whom the order is issued refuses to cease and desist from the practice complained of, the Commission may apply to a court for enforcement. The court may affirm, modify, or set aside the order. The Trade Commission Act states, however, that the findings of the Commission as to the facts, if supported by testimony, shall be conclusive. As in all other cases, appeal may be had to the Supreme Court of the United States, provided there is satisfactory reason for it to hear an appeal.

The person against whom the order is issued may also appeal to the courts. In no case is an order of the Commission to relieve or absolve any business from liability for combining to restrain trade, under the antitrust acts. If a competitor has sustained injuries, he may obtain threefold damages as provided in the Sherman Act.

In preventing unfair competition, the Commission may act as grand jury, prosecutor, and judge. The triple function of the Commission will be evident from a consideration of the procedure

[1] Federal Trade Commission *v.* Raladam Co., 283 U.S. 643 (1931).

that it follows in dealing with instances of unfair competition as they arise. Complaints of unfair methods of competition may come before it in any one of several ways. The most common origin of complaints is a letter from a competitor, a customer, or a trade association, though the Commission itself may originate a complaint if it so wishes.

When any complaint is received, the Commission studies it to determine whether to act. It must be sure: first, that the practice complained of is being carried on in interstate commerce; second, that it is an unfair method of competition; and third, that action by the Commission would be in the public interest. Many hundreds of complaints are thrown out at this stage because they do not afford a basis for action. If the Commission decides to act, it assigns the case to an examining attorney for investigation. The business against which charges are being considered may be interviewed and asked to make an explanation. (The name of the party advising the Commission of the alleged unfair practices is not disclosed, so as not to discourage persons from making such reports.) The examining attorney, after securing all available information, summarizes the evidence, reviews the law, and makes his recommendation. The procedure to this point is secret, the purpose being to protect the person under investigation until the Commission has decided whether public action should be taken.

In many instances, the business against which the charges have been made admits that its methods are unfair and agrees to cease and desist from the unlawful practice without contesting the case. A settlement by agreement is known as a *stipulation*. The stipulation fully protects the public, since the company that is being investigated agrees to cease and desist from the alleged unfair methods. There is no appeal from a stipulation, and the cost to the government and the private business is small. Moreover, many cases are settled by stipulation where it would be difficult for the Commission to obtain sufficient evidence to procure an order to cease and desist.

If agreement is not reached through a stipulation, the Commission may decide to issue a formal complaint. The business against which the complaint is made may or may not reply. Failure to reply within twenty days is considered an acknowledgment of guilt. In a contested case, the Commission hears the evidence and also has its attorneys to represent it in the prosecution. After testimony has been taken, the trial examiner prepares his report of the case for

the Commission and also for the attorneys of both sides. The case is then argued before the Commission, which reaches a decision either sustaining the charges or dismissing the complaint. If the charges are sustained, an order to cease and desist is issued.

The courts and not the Commission have authority to decide what constitutes unfair methods of competition. As the Supreme Court has said, the meaning of the phrase "unfair methods of competition" must be arrived at by the "gradual process of judicial inclusion and exclusion." However, the courts have not always been sure of what is fair and what is unfair. In one case, the Supreme Court said that:

> . . . the words "unfair method of competition" are clearly inapplicable to practices never heretofore regarded as opposed to good morals because characterized by deception, bad faith, fraud or oppression, or as against public policy because of their dangerous tendency unduly to hinder competition or create monopoly. The act was certainly not intended to fetter free and fair competition as commonly understood and practiced by honorable opponents in trade.[2]

This was a very narrow view, particularly since it is known that new methods of competition are devised from time to time.

A much broader view of the meaning of unfair competition has been taken in recent decisions. In a case involving the question of the legality of the sale of candy through lottery schemes, the Supreme Court declared that "it is unnecessary to attempt a comprehensive definition of unfair methods which are banned, even if it were possible to do so. . . . New or different practices must be considered as they arise in the light of the circumstance in which they are employed."[3] And in another case the court said that it is the duty of the Commission "to discover and make explicit those unexpressed standards of fair dealing which the conscience of the community may develop."[4] The court added that the Commission is not to sanction unfair practices merely because they are of long standing. "Its duty is to bring trade into harmony with fair dealing."

A method of competition may be unfair even though it may not appear that any individual competitor has been injured. This principle was set forth in the Winsted Hosiery Company case.[5]

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[2] Federal Trade Commission *v.* Gratz, 253 U.S. 421 (1920).

[3] Federal Trade Commission *v.* Keppel and Brother, 291 U.S. 204 (1934).

[4] Federal Trade Commission *v.* Standard Education Society, 86 Fed. (2d) 692 (1936).

[5] Federal Trade Commission *v.* Winsted Hosiery Company, 258 U.S. 483 (1922).

This company branded men's underwear and other garments as wool, when in fact they were made only partly of wool. The company contended that no competitor was injured, since all manufacturers followed the same practice of labeling and advertising the same articles of clothing. Garments made wholly of wool were labeled and advertised as "all wool." The court held, however, that since the labels were literally false, they were calculated to deceive a substantial portion of the purchasing public. Thus, the proceeding against the company was justified on the ground that it was in the public interest to stop the practice. It was held to be of no consequence that other manufacturers might misbrand their product, for the practice was an unfair method of competition as against those manufacturers of mixed wool and cotton underwear who brand their product truthfully and against manufacturers of all-wool underwear. It was considered unnecessary to prove what competitors had been injured.

The Winsted Hosiery case resulted in a far-reaching change in the law and established a precedent of the greatest significance. By the common law, a manufacturer can incorrectly label his product, and there is no remedy to either competitors or the public unless it is the right to sue for damages. In misrepresentation cases, the right to sue for damages is of little value because it is impossible for anyone to prove injury. As a result of the decision in the hosiery case, however, proof of damages is now unnecessary, and misrepresentation of any kind is illegal.

Many methods of competition are now prohibited. The illegal practices include many which were formerly quite common. It is impossible to give a complete list of unfair methods, but the following are illustrative: [6]

1. *Misbranding of goods offered for sale.* This involves, first, the practice of misrepresenting the material of which a product is made, such as calling a product wool when it is only partly made of wool, or silk or satin when in fact it is made of cotton. Other names often improperly used for a cheap or adulterated substitute are linseed oil, turpentine, ivory, rose-quartz beads, manila rope, seal plush, olive-cream castile soap, cucumber-cream castile soap, graphite-carbon roof paint, art leather, pearls, silverware, and the like. If a product is adulterated with a cheaper substance, as lin-

[6] For a comprehensive list of unfair practices, see *Annual Report of the Federal Trade Commission,* 1944, p. 38, or report for any other recent year.

seed oil mixed with a cheap mineral oil, the manufacturer cannot use the name of the better substance on the label unless he also uses the name of the cheaper substance in type equally conspicuous.

In some cases, the misrepresentation of the product has involved the use of a name which merely suggests a better ingredient than that actually contained in the product. For example, such words as "cilk," "sylk," or "silkoline" have been used to designate a product not made of silk, or "squirlpelt" to designate a garment made of cotton and wool.

The misbranding of the product, in still other instances, takes the form of misrepresentation of its origin or source. Goods may be sold under such names or circumstances that the purchaser is led into thinking that he is buying direct from a manufacturer when in fact he is not. For example, a company engaged in the sale of furniture was ordered to cease using the words "factory," "manufacturers," and "manufacturers selling direct to the public" until it actually owned or operated factories in which the furniture was made. Other complaints have involved the use of a picture of a factory on the letterhead of a retail store, and the use of such phrases as "manufacturer's outlet," "mill," "laboratory," and "distiller."

Misbranding also may result in misrepresentation of the city or country in which an article has been manufactured or grown. Certain cities have established a reputation for producing goods of exceptional quality, and manufacturers or retailers may misrepresent the source of their goods to take advantage of such reputation. The Grand Rapids Upholstering Company was ordered to cease using the words "Grand Rapids" as a trade name or in advertising, until the furniture thus designated was made in Grand Rapids. Another manufacturer was ordered to cease using the words "C'est Français," unless he used other words in type equally conspicuous to indicate that the article was manufactured in the United States.

2. *Selling second-hand or rebuilt articles as new.* Some of the early complaints on this score were against companies that had bought old automobile casings, revulcanized them and added new treads, and sold them as new; the tires looked like new but proved defective when used for a short time. Similar complaints were issued against the sale of rebuilt typewriters as new. Moving-picture manufacturers were also ordered to cease representing that old pictures issued under a different name were new. Complaints have

been issued against hat manufacturers who bought used and discarded men's felt hats, renovated them, and sold them as new. The process of renovation included dry-cleaning, steaming, shaping, relining, and fitting with new ribbons, sweatbands, and size-labels. The new linings bore various trade-names and manufacturers' names.

3. *Misleading advertising.* A jewelry store was ordered to cease using the phrase "stands the tests of fire and the acid bath" in advertising imitation diamonds. A correspondence school giving instruction in practical electricity was ordered to cease representing that students completing its course were generally able to earn salaries from $60 to $200 a week. The Doctor Rodney Madison Laboratories was ordered to cease representing that Doctor Rodney Madison was a descendant of James Madison, the fourth President of the United States.

4. *Misrepresentation of the price at which the product was intended to be sold.* This method consists in misleading the purchaser into believing that for some reason he is being offered the product or service at a cut rate when such is not the case. For example, a correspondence school for physical culture was ordered to cease falsely representing that the prices quoted were special reduced prices for a limited time only. Other such schemes include: (1) the use of "free" goods or services to create the false impression that something is being thrown in without charge, when in fact its price is fully covered by the amount asked in the transaction taken as a whole; (2) the use of exaggerated retail prices in connection with or upon the containers of commodities intended to be sold as bargains at lower figures.

5. *Misrepresenting the terms upon which a product is sold.* Salesmen offering encyclopedias and reference works for sale claimed that purchasers would receive the books free upon subscribing to research or extension services. In fact, the purchase price fully compensated the company for both the books and the extension service. The alleged reason for the free offer was that the purchasers were on preferred lists of the company for advertising purposes.[7] This same company represented its books as new when in fact they were an old publication in a new edition, and it included in its list of contributors the names of many persons who had not contributed

[7] Federal Trade Commission *v.* Standard Education Society, 58 Sup. Ct. 113 (1937).

articles. It also stated that its price was a special or reduced price. All of these practices were considered unfair.

6. *Disparagement of competitors.* False statements concerning the quality of the product of a competitor, and false statements to the effect that a competitor has applied for a receiver or that he is a member of a trust, have also been the cause of complaints issued by the Commission.

7. *Threats of patent suit.* This practice is illegal if the threats are made not in good faith but for the purpose of intimidating the trade and hindering competition.

8. *Commercial bribery.* The bribery of the employees of another company often takes the form of payments in cash, though the payments may be in merchandise. The Commission has issued a large number of orders against the practice. Trade associations and associations of purchasing agents have assisted the Commission in attempting to stop it. One reason for the failure to stop this practice was that the courts very early overruled the Commission with respect to the legality of giving liquors, cigars, meals, theater tickets, and other entertainment to prospective customers.[8]

9. *Sale of candy through lottery schemes.* The sale of candy through the use of punchboards, prize packages, lottery schemes, and other devices involving an element of chance have been held to be illegal on the ground that these methods of sale affect potential competition and are injurious to dealers in straight candy.[9]

10. *Bogus independents.* The practice of maintaining a subsidiary corporation as an ostensible competitor is illegal.

11. *Imitating standard containers.* A product may be sold in a standard container or in a carton or bottle that resembles a standard container and that is associated in the mind of the public with standard weights or quantities of product, whereas in fact the weight or quantity of the product sold is less than the standard. For example, a manufacturer who puts up butter in packages containing 3½ ounces, 7 ounces, and 14 ounces without clearly indicating the weight is likely to deceive the public into thinking that the packages contain standard weights.

12. *Procuring trade secrets of competitors by espionage.*

[8] New Jersey Asbestos Co. *v.* Federal Trade Commission, 264 Fed. 509 (1920).

[9] Federal Trade Commission *v.* Keppel and Bro., 291 U.S. 204 (1934); Hofeller *v.* Federal Trade Commission, 82 Fed. (2d) 647 (1936); Federal Trade Commission *v.* Martioccio Co., 87 Fed. (2d) 561 (1937).

13. *Inducing employees of competitors to violate their contracts.*

14. *Paying excessive prices for supplies for the purpose of controlling the market and eliminating competition.*

15. *Concealing business identity in selling a product.*

By the common law some of the practices in the foregoing list were illegal provided any one business could prove damages. Even in such cases, the work of the Commission is significant because it may take action to stop the practice in the public interest. For various reasons, the right of a business to sue for damages is not adequate protection to the public which has an interest in the maintenance of competition and in the preservation of business opportunities for all.

Several practices that the Commission regarded as unfair are, in fact, legal. In dealing with a difficult problem such as unfair competition, it might be expected that differences of opinion between the Commission and the courts would arise. Moreover, it is doubtful that the Commission would have been doing its full duty if it had avoided all border-line cases and had not asked the courts for a decision as to the legality of certain methods. When the Commission was first established and it had few legal precedents to serve as a guide, its decisions were frequently overruled; but in recent years it has been much more successful. The principal practices which the Commission has held to be unfair but which the courts think are fair are as follows:

1. *Gifts of premiums by a manufacturer to the salesmen of a retailer, given with the knowledge and consent of the retailer.* The purpose of such gifts is to induce the salesmen to urge the sale of the goods upon the buying public, which has no knowledge of the interest of the salesperson.

2. *Leases of gasoline pumps to retailers at a nominal rental on condition that only the gasoline purchased from the lessor be sold from the pumps.* The objection of the Commission was that such pumps represented a large capital investment, and that competitors of the lessor company were not financially able to supply pumps on the same terms. The effect was to limit the sales of the retailer to the products of the wholesaler supplying the pump.

3. *The refusal of the wholesaler to buy from a manufacturer unless the manufacturer ceases to sell to a competitor of the wholesaler.*

4. *The classification of the customers of a manufacturer as retailers, wholesalers, jobbers, and so forth, with different trade discounts to each.*

5. *The use of testimonials for the product of a company, when such testimonials have been paid for, without disclosure of the fact that they were paid for.* If the testimonials are true statements of opinion, it is not necessary to state that they have been paid for.

Conferences are held by representatives of an industry to improve competitive conditions. A meeting between members of an industry and representatives of the Federal Trade Commission for the discussion of unfair methods of competition is called a trade-practice conference. Such conferences are usually held after application to the Commission has been made by the industry. Representatives of the industry discuss practices and methods of competition that should be eliminated in the interests of the industry and the public. Resolutions are framed and voted upon. After adoption, the rules are promulgated and businesses are urged to observe them. The purpose is largely educational. If the practices which are condemned are illegal as well as unethical, the aid of the Federal Trade Commission may be invoked to require observance.

The practices prohibited by the rules adopted at trade practice conferences are similar to those previously mentioned except that they are usually more specific and more detailed in their application to the problems of the industry. They include such practices as the following:

Deceptive packaging.
Disparagement of the products of a competitor.
Obtaining trade secrets through misrepresentation or deceit.
Price discrimination to injure or destroy competition.
Discrimination between customers in the matter of discounts or free services.
False invoicing, allowing lower prices than those stated in the invoice.
Imitation of the trade-marks or trade-names of competitors.
Use of deceptive photographs in the sale of the product.
Use of loss leaders.
Deceptive sales of regular lines as close-outs.
Falsely representing sales as special or limited.
Misuse of such terms as extra fancy, extra select, de luxe, choice, etc.
Failure to disclose remaining shrinkage in pre-shrunk merchandise.
Failure to disclose that articles are imitations and not real or genuine.

Much has been accomplished in the improvement of competitive

practices. As a result of the work of trade associations and of the Federal Trade Commission, the level of competitive practices has been greatly improved. The improvement is especially notable in the labeling of products, in the statement of ingredients, and in advertising. The Commission maintains a continuous scrutiny of advertising in magazines, newspapers, farm and trade journals, almanacs, and mail-order catalogues, and also by radio. The claims of advertisers are much nearer the truth than would be the case without the law, though the reader must still discount the "puffing and praising of wares" by the seller.

Whether the Federal Trade Commission has accomplished its larger purpose of preventing the growth of large enterprises and monopolies is more difficult to decide. The difficulty is that no one can say with certainty what the situation would have been if the use of unfair methods had not been made illegal. It seems to be true, however, that most large corporations as well as small ones which value their goodwill have given up any use of unfair methods. Enforcement measures are necessary against only a minority. This has been an accomplishment of genuine social value.

Questions

1. What is the relation of competitive methods to the growth of large corporations?
2. What is the difficulty in defining unfair methods of competition?
3. What is the penalty for the use of unfair methods of competition?
4. What is the objection, if any, to permitting the Federal Trade Commission to bring the charge, prosecute the case, and render the decision in unfair competition cases? Do any other Federal agencies have the same powers? Do the same individuals act in all three capacities? Is the defendant sufficiently protected by his right to appeal to the courts?
5. What is a stipulation? In what way may it be subject to abuse? What are its advantages?
6. How have the courts defined unfair methods of competition?
7. What is the significance of the Winsted Hoisery case? How did it change the law as previously interpreted by the courts?
8. What methods or phases of misrepresentation are illegal under the Federal Trade Commission Act?
9. Why is misrepresentation of the intended sales price an unfair method? If the purchaser inspects the article and likes it, what difference does the intended sales price make?
10. What is commercial bribery? If a manufacturer gives a bribe, can he rightfully complain of the practice?

11. Does the giving of cigars constitute commercial bribery? Is it bribery if the salesman takes the prospective purchaser to lunch?

12. Why are lottery schemes for the sale of candy considered unfair?

13. Is it an unfair method to sell religious mottoes or trinkets with the promise that they will protect the purchaser from harm in battle?

14. If an advertiser pays for testimonials, should he be required to disclose the fact?

15. What is a trade practice conference? What are the advantages of such conferences? Do you see any objections to them?

16. In what ways have competitive methods been improved since 1914?

CHAPTER XXXIV

The Control of Competitive Practices in Merchandising

The regulation of competitive practices in merchandising is the result of the rise of the corporate chain store and of agitation by trade associations of retailers and wholesalers. The legislation is stated in general terms and therefore applies to all merchandising businesses, but it was intended to curb chains. The agitation for such legislation began to be effective near the close of the decade of the twenties as chains grew rapidly in number of stores and sales volume. Following the crisis of 1929, the plight of the independent retailer appeared to grow worse, and legislation was enacted in several states. Further relief was afforded after 1933 by the codes promulgated under the provisions of the National Industrial Recovery Act; but when that Act was invalidated by the Supreme Court in 1935, the agitation for new legislation was revived and more states passed legislation to control retail stores. The measures regulating competitive practices in merchandising are summarized as follows:

1. State taxes on chain stores.
2. The prohibition of sales below cost. These laws are called the Unfair Practices Acts.
3. Regulation of the relations of the retailer to wholesalers and manufacturers.
    a) Resale price maintenance laws, which permit a manufacturer to prescribe the minimum retail price of his product. These laws are called the Fair Practices Acts.
    b) Anti-discrimination legislation, which prohibits a manufacturer or wholesaler from discriminating in prices or otherwise between his customers. This is the Robinson-Patman Act (Federal law).

The first line of attack upon the chain store was through taxa-

tion. The first states to levy taxes against chain stores were Indiana and North Carolina in 1929. During the next ten years almost half of the states enacted chain store taxes of some kind. The most common plan is a tax graduated according to the number of stores owned and operated by the chain within the state, although in Louisiana the tax is calculated according to the number of stores operated in the United States. In any case the tax per store increases with the size of the chain. The usual minimum rate per store is $1; but it is as much as $50 in some states. The usual maximum rates are from $150 to $300. The constitutionality of the chain store taxes of Louisiana and also some of the other states has been upheld by the United States Supreme Court.

The agitation for chain store taxes leveled off after 1935 in much the same way that the chain store growth had itself leveled off after 1930. The legislatures ceased to enact new taxes on chains, and in 1938 a proposed Federal tax agitated by Representative Patman failed of enactment. This was the crest of the attack upon chains. After the United States was drawn into the war in December, 1941, the agitation rapidly subsided as a result of man-power shortages and a growing concern over the threat of rising prices.

Another reason for the decline of the tax agitation was that during the years 1935 to 1939, anti-chain store taxes were invalidated as discriminatory in several states. In some states the taxes were reënacted in a different form, but in other states they were dropped. The Kentucky tax, which increased in rate as the volume of sales increased, was held to be unconstitutional for the reason that it exacted from different persons different amounts for the privilege of doing exactly similar acts because one person performed the act more often than another.[1] In declaring a special tax on supermarkets unconstitutional in 1939, the Supreme Court of New Jersey said:

> The municipality may not require its residents to forego the exercise of an economy in order that a group of merchants, unwilling to take advantage of economy and management, may prosper. A community cannot by imposition of a license tax for revenue, confiscate the property of one merchant merely because he offered his merchandise for sale in one manner rather than another.[2]

Two developments in the organization of chain stores may be attributed at least in part to the taxes. First, there has been a trend

[1] Stewart Drygoods Co. *v.* Lewis, 294 U.S. 550 (1935).

[2] Great Atlantic and Pacific Tea Co. *v.* Camden, 4 Atl. (2d) 16.

toward a smaller number of large stores or supermarkets. Second, some chains, especially chains of filling stations controlled by the refining companies, have reorganized by leasing the station to the manager for a fixed rental, coupled with a contract for the sale of the products of the refining company owning the station. This type of organization is commonly called the "Iowa Plan."

Sales below cost are illegal in several states. The prohibition of sales below cost is a horizontal provision applying to all articles. In this legislation, California has led the way. The first such law was enacted in 1913, but this law was dormant until the effects of the demoralization of price levels began to be felt in 1931 and 1932. As amended in 1935, the law provides that it shall be unlawful to sell an article below its original purchase price plus a pro rata amount of the distributor's cost of doing business. The cost of doing business includes rent, labor, interest, depreciation, selling expenses, maintenance, delivery, credit losses, license taxes, property taxes, insurance, and advertising. If market prices have declined since an article was purchased, the minimum sales price is replacement cost plus a percentage of the operating expenses or costs of doing business. A retailer is permitted to sell below cost as thus defined only if necessary to meet the prices of a competitor, to close out a line of merchandise, or to liquidate a bankrupt or insolvent business. This legislation is generally referred to as the Unfair Practices Act.

The prohibition of sales below cost is difficult to enforce. It is difficult to determine what the full cost of a retailer is in connection with an individual item or line of merchandise, and further difficulties are encountered in establishing proof that the purpose is to injure competitors and not actually to meet their prices.[3] In California the law has been used largely as a threat and in an educational manner. There have, however, been a few prosecutions. Trade associations of retailers, wholesalers, and jobbers in a number of industries, particularly groceries, drugs, and tobacco, have organized to police their trades to prevent violations of the law.

Many manufacturers and retailers have long favored resale price maintenance. As defined by the Federal Trade Commission, "resale price maintenance is that system of distribution under which the manufacturer of trade-marked or otherwise identified goods names the prices at which his products shall be sold and

[3] Malcolm McNair: "Marketing Functions and Costs and the Robinson-Patman Act," *Law and Contemporary Problems*, June, 1937, Vol. 4, pp. 334-351.

distributed by wholesalers and retailers, thus controlling the margins realized by distributors and the prices paid by consumers."[4] Some manufacturers have favored this policy because price cutting has often limited their markets. The cut price causes other retailers to cease to feature the item at regular prices even though they continue to carry it in stock, while many retailers will cease to carry it at all. The item immediately loses its attractiveness to the price cutter, and he therefore features another item. Thus, the manufacturer may lose both his established and his cut-price retail outlets. Manufacturers also favor resale price maintenance because price cutting causes pressure to be brought upon them to lower their prices to independent dealers who must compete with the price cutter. A further objection of the manufacturer to price cutting is that in his advertising he often features price. If the manufacturer advertises one price and retailers sell for less, the manufacturer suffers in loss of consumer goodwill.

Retailers object to price cutting because a portion of their business becomes unprofitable. They argue that large chains and department stores have an unfair bargaining advantage because of their large volume. A further argument is that it causes undue emphasis to be placed upon the price rather than the quality of the merchandise or the services rendered by the store.

Until recently the public attitude has been one of opposition to price maintenance. To permit the manufacturer to prescribe the retail price of his product is to deprive the public of the benefit of competition in its sale. Price maintenance, it is alleged, not only ends price competition but also puts the inefficient store on the same competitive basis as the efficient and thus tends to destroy the initiative that has characterized private enterprise. It also causes retail prices to become rigid and deprives the public of the benefit of low prices.

Resale price maintenance contracts were illegal under the antitrust acts. It was decided as early as 1911 that resale price maintenance contracts were illegal under the Sherman Antitrust Act because such contracts deprived the public of the benefits of competition in the subsequent traffic in the commodity.[5] Even the holder of a patent could not prescribe the price at which others should resell the product manufactured by him. Later it was de-

[4] Federal Trade Commission: *Resale Price Maintenance,* Part I, p. 2 (1929).

[5] Dr. Miles Medical Co. *v.* Park and Sons Co., 220 U.S. 373 (1911).

cided in the Colgate Company case [6] that a company could exercise some control over resale prices through a refusal to sell to price cutters. This was legal under the Sherman Antitrust Act and the Clayton Act because under the Clayton Act any business has the right to choose those with whom it will deal and to announce the circumstances under which it will sell. Under the Federal Trade Commission Act, however, it was held that the Beech-Nut Packing Company had employed illegal methods in its attempt to control resale prices. This company adopted a schedule of resale prices for all dealers in its products, including jobbers, wholesalers, and retailers. The company employed agents to make reports of dealers who sold the product, and it enlisted the aid of retailers in maintaining the prices fixed. It also marked its products with serial numbers in order that it might trace the sources of supply of price cutters. These activities, in the opinion of the Supreme Court, amounted to a tacit agreement between the company and the retailers to maintain prices, and the policy of the Beech-Nut Company was therefore illegal.[7] The general rules prescribed in the Beech-Nut case have been followed in subsequent cases.[8]

In addition to refusing to sell to price cutters, the following methods could be employed by a manufacturer in meeting the problems created by price cutting: he might sell through exclusive agents, depriving any person of his agency if he cut the price; he could sell on consignment, title to the merchandise remaining with the manufacturer until sold to the ultimate consumer; he might minimize the effects of price cutting by manufacturing two different brands, only one of which was sold through chain stores or others who usually cut the price; he might also recommend a resale price and urge retailers to sell at that price; by advertising his product extensively, he might create such a strong consumer demand for his product that retailers would be forced to carry it in stock even though price cutters had made the article unprofitable.[9]

Public opinion has recently become more favorable to resale price maintenance. The change in public opinion has come largely as a result of the rapid growth of chain stores. A policy of uncon-

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[6] United States *v.* Colgate and Company, 250 U.S. 300 (1919).

[7] Federal Trade Commission *v.* Beech-Nut Packing Co., 257 U.S. 441 (1922).

[8] See, for example, Armand Co. *v.* Federal Trade Commission, 84 Fed. (2d) 973 (1936).

[9] See Albert Haring: *Retail Price Cutting and Its Control by Manufacturers.* Ronald Press Co., New York, 1935.

trolled competition, many persons believe, has forced many small merchants out of business and has led to increased power in the hands of a relatively small number of chains. The opposition to chains was strengthened in 1934 and 1935 by the reports of the Federal Trade Commission, which indicated that a large part of the advantages of chain stores resulted from their ability to buy at lower prices.[10] Moreover, it was felt that chain stores had received low prices from manufacturers not only because the costs to the manufacturer are less when he sells in large volume but also because the chain is in a position to bargain and to force concessions.

Resale price maintenance contracts are now legal in many states. The first state to legalize resale price maintenance was California in 1931. Most of the states now permit price maintenance in branded products. The usual provision is that a manufacturer may contract with a wholesaler, or other person to whom he sells, to fix the actual or the minimum retail price; and the price thus established cannot be cut by any dealer even though he is not a party to the contract. This provision is enforced by having the manufacturer attach to the product a statement indicating what the retail price is to be. Acceptance of the goods is declared to constitute an agreement not to retail them for less than that price.[11]

Sales below the established price are usually permitted only under the following conditions:

1. Closing out of the stock for purposes of discontinuing the sale and delivery of the commodity. Some state laws require that the retailer offer the unsold merchandise to the manufacturer at the original invoice price before placing it on sale to the public at cut prices.

2. When the goods are damaged or deteriorated in quality and are sold as such.

3. When the goods are offered for sale by any officer acting under orders of a court.

The constitutionality of this legislation has been upheld by the United States Supreme Court.[12] The decision was based princi-

[10] Federal Trade Commission: *Final Report on Chain Stores,* 1935.

[11] For discussion of resale price legislation, see E. T. Grether: "Experience in California with Fair Trade Legislation," *Calif. Law Review,* Sept., 1936, Vol. 24, pp. 640-700; also Breck P. McAllister: "Price Control by Law in the United States," *Law and Contemporary Problems,* June, 1937, Vol. 4, pp. 273-300.

[12] Dearborn Distributing Co. *v.* Seagram Distillers Corp., 57 Sup. Ct. 139 (1936); also The Pep Boys *v.* Pyroil Sales Co., 57 Sup. Ct. 147 (1936).

pally on the argument that the manufacturer has the right to protect his goodwill, which may be injured by price cutting. The goodwill, said the court, is embodied in the trade-mark attached to the commodity. This belongs to the manufacturer, in contrast with the commodity itself, which belongs to the retailer.[13]

The Federal government has legalized certain price maintenance contracts in interstate commerce. In August, 1937, the Sherman Act was amended to permit price maintenance contracts for the resale of a branded or trade-marked commodity when such contracts are legal in intrastate commerce in the state in which the sale is made. It is expressly provided, however, that such contracts cannot be made between dealers or between manufacturers. In other words, the price maintenance contracts are legal when made vertically but not horizontally in an industry. The Federal legislation is commonly referred to as the Tydings-Miller Act.

The argument made for this legislation was that Congress should remove any obstacle in the way of the states that were trying to help the independent retailer.[14] Critics of the bill contended, however, that the principal purpose of trade associations sponsoring the measure was to obtain Federal approval of their program in order that they might find it easier to have price maintenance legislation enacted in those states where such contracts were still illegal.[15]

The price maintenance legislation thus far has not had significant results. During the war period, price cutting ceased to be a problem. Consumers were not greatly concerned with the price of many items which were scarce, but were more interested in knowing where merchandise could be purchased. The efforts of government agencies were directed at the prevention of price increases rather than price cutting. Many retailers discontinued their businesses; but as pointed out in Chapter II, there were many reasons for their difficulties. The principal advantage of the chain store during the war period was in having a more dependable source of supply than many independent retailers had.

Before the war, and during the war on items that were in fairly plentiful supply, the price maintenance legislation was not particularly effective. In the first place, the law is permissive and not

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[13] See Sumner S. Kittelle: "The Fair Trade Decision and the Growth of Resale Price Maintenance Legislation," *George Washington Law Review,* Nov., 1937, Vol. 6, pp. 110-126.

[14] Report of the Senate Committee on Judiciary, 75th Cong., 1st Sess., Report 257 (1937).

[15] Hearings before Committee on Judiciary, S. 100, 1937, especially statement of Emanuel Celler, p. 52.

mandatory, the manufacturer being permitted to prescribe either the actual or the minimum retail prices if he so desires. Moreover, its provisions apply only to branded trade-marked articles. The branded article must compete with unbranded merchandise, brands of other manufacturers, and private brands of chains and other retailers. Manufacturers hesitate to prescribe a retail price because their sales volume might be affected. Where resale prices are established by contract, the level is usually below the prices charged by many retailers. In some cases, however, chains have been required to increase their prices on branded merchandise, but they can cut the prices on unbranded merchandise and on their private brands.

The Robinson-Patman Act prohibits price discrimination between purchasers. This law provides that it is unlawful for any person to discriminate in price between purchasers where the effect of such discrimination may be substantially to lessen competition, or tend to create a monopoly, or to injure, prevent, or destroy competition. The seller may establish only such differentials in price as make allowance for differences in the cost of manufacture, sale, or delivery resulting from differences in methods or quantities sold. The Federal Trade Commission, which is authorized to enforce the Act, is authorized to revise the quantity limits where it finds that available purchasers in the greater quantities are so few as to render the price differentials discriminatory.

A special provision prohibits the payment of brokerage fees to a purchaser or his agent except as compensation for services actually rendered. This provision is directed at the practice of large chain-store organizations in purchasing through a separate department of their company. In effect, the payment of a brokerage fee may constitute a reduction in the price of the merchandise.

In form, the Robinson-Patman Act is an amendment to the Clayton Act of 1914, but the purposes of the two laws are entirely different. The Clayton Act, which prohibited price discrimination between purchasers where the effect may be to lessen competition or tend to create a monopoly, was designed to protect all buyers against the monopolistic schemes of a manufacturer who was attempting to destroy his competitors. The new legislation is designed to protect one buyer from another, and thus to prevent the growth of monopolies in the field of distribution.[16]

[16] E. P. Learned and Nathan Isaacs: "The Robinson-Patman Law," *Harvard Business Review*, Winter, 1937, Vol. 15, pp. 137-155; also Melvin T. Copeland: "The Problem of Administering the Robinson-Patman Act," *ibid.*, pp. 156-173.

Prior to the Robinson-Patman Act, many manufacturers charged their customers different prices. While most retailers have voluntarily adopted the policy of charging only one price for a commodity for all customers, wholesalers and manufacturers have not usually done so. Retail stores which buy from them do not purchase similar quantities, and they do not require similar services. For example, department stores and chain stores usually send their buyers to the market, whereas small retailers cannot afford to do so. Thus, the trade of smaller businesses must be solicited by manufacturers at increased cost, which is reflected in higher prices. The large distributor with a substantial advertising budget can also advertise and promote a product much more effectively for the manufacturer than can a small retailer who sells in a limited market and advertises in a very small way. For this promotional service of the chain store or department store, the manufacturer has often granted a direct discount or has indirectly reduced his price by bearing a part of the advertising cost or paying the retailer an advertising allowance. Different retail outlets also have special problems which require special treatment. Manufacturers have sometimes found it advisable to pay demonstrators who show and sell their product in the retail store, or to pay push money to the clerks. Freight allowances have also been paid by manufacturers. In some cases these were disguised price concessions, which now become illegal if they result in discrimination. A low price on a private brand manufactured for a retailer may also be a discrimination within the meaning of the Act.

The large distributor may still obtain a price advantage over the small retailer. One method that the chain may employ is to manufacture its own product or can its own food supplies. Integration may also proceed from the other direction with the manufacturer acquiring control of the retail store. Large distributors may also purchase the entire output of canneries or factories, although this practice involves considerable risk for the factory owner because it makes him entirely dependent upon the chain for his market. Sales may be made on the consignment plan, which makes the retailer the agent of the manufacturer in handling his product. Another method of evasion is the conversion contract where the chain buys the raw material and contracts with the manufacturer for processing it.[17] This method was often employed by chain stores even be-

[17] "The Robinson-Patman Act in Action," *Yale Law Journal*, Jan., 1937, Vol. 46, pp. 447-482.

fore the Robinson-Patman Act was passed. To the extent that any of these methods are employed, the position of the large distributor in the trade will be strengthened and the purpose of the Act will be defeated.

Even with the anti-discrimination legislation the relative position of the small independent will not be greatly strengthened: first, because many of the quantity discounts and other price concessions granted to the chain store by manufacturers will be found to have economic justification; and, second, because without price concessions, many large chain stores and other distributors can sell for lower prices than the average independent service store.

The significance of the anti-discrimination legislation has been as follows: first, it has resulted in the elimination of many of the grosser inequities and discriminations against small purchasers; second, manufacturers and other distributors have used the legislation as justification for the voluntary elimination of many discounts and allowances that might actually be legal or whose illegality would be difficult to prove; third, arbitrary discounts formerly granted as brokerage payments have been largely discontinued. In some instances, fake brokerage payments have been voluntarily discontinued by manufacturers, and in other cases the provisions of the Robinson-Patman Act have been invoked by the Federal Trade Commission to compel their discontinuance.

In recent years the complaints which have been issued under the Robinson-Patman Act have not been against corporate chain stores, which were supposed to be the principal offenders in the demanding of rebates and allowances.[18] Instead, the complaints have been issued against coöperative chains and single proprietors operating independent stores. However, the Department of Justice has brought some suits against corporate chains under the Sherman Act alleging that they were demanding and receiving discriminatory prices. For example, in 1945 suit was pending against Safeway Stores and its officers on the charge that the company had received special discounts, rebates, advertising and promotional allowances, floor space rentals, sign space rentals, and payments for other pretended services rendered to suppliers but in reality performed in the ordinary course of selling the merchandise of the store.[19]

The demand for anti-chain store legislation has come largely

[18] Federal Trade Commission: *Annual Report,* 1944, p. 53.

[19] Suit filed in 1943 in the District Court of Kansas.

from organizations of independent retailers. The consumers who desire low prices and cheap and efficient methods of distribution have not been organized to make their wishes known or to protect their interests. Ultimately, a proper balance must be reached between an unfair use of loss leaders and the placing of limitations upon the legitimate activities of efficient distributors. The manufacturer or the retailer who can lower distribution costs is performing a social service. Legislation that penalizes a distributor because he is efficient is unfair to both the distributor and the consumer.

Questions

1. What has been the effect of taxes on chain stores?
2. Why has the agitation for chain store taxes subsided?
3. Should a retailer be permitted to sell below cost if he desires to do so?
4. What does cost include? Can a reliable cost be determined?
5. What has been the effect of the prohibition of sales below cost?
6. What is resale price maintenance?
7. Why should a manufacturer wish to fix a minimum price for his product? Might he also wish to fix a maximum price?
8. Is resale price maintenance socially desirable?
9. What could a manufacturer do under the antitrust laws to prevent retailers from cutting the price of his product?
10. How did the Colgate Company case differ from the Beechnut case?
11. Under what conditions may a retailer sell below the price established by the manufacturer?
12. Is a retailer a party to the contract by which the minimum retail price of the product of the manufacturer is fixed? How can he be required to observe it?
13. What has the Federal government done to legalize resale price maintenance?
14. What is the purpose of the Robinson-Patman Act? What does it provide?
15. Why would a manufacturer wish to sell to one customer at lower prices than to another?
16. What forms may discrimination between customers take?
17. Can the chain store still have a price advantage over the independent retailer? How?
18. What has been the effect of the Robinson-Patman Act?

CHAPTER XXXV

Recent Developments and Trends

From the welter of legislation, court decisions, and opinions with which the student of business organization is confronted, one often finds it difficult to draw any coherent body of observations and conclusions. Indeed, the lawyers and judges themselves are often confused and without definite guiding principles. In the present section, we shall summarize some of the causes of difficulty and undertake to obtain a more general view of some of the problems.

The states have been transferring an increasing share of the control problem to the Federal government. The gradual abandonment of attempted control of both the corporation and the combination in restraint of trade in its various forms has been manifest for many years. The transfer of the power of granting corporate charters from the legislature to the office of the secretary of state, while no doubt justifiable on many grounds, was the first step in the abandonment of effective control of the corporation. This was followed by the increasing liberality of the general incorporation statutes, making it easy to build up great holding-company systems and consolidated companies under state grants of authority. Individual states then attempted to break up the large combinations under their antitrust laws, but without success. Realizing that the problem was not one that could be coped with by the states, the enforcement officers of various states have one by one permitted the legislation to become dormant except in cases of relatively small local businesses. Consequently, a problem that the states have helped to create has been transferred to the Federal government, which has been under the necessity of taking action in the general interest.

Much of the Federal legislation is conflicting in principle. The greater part of the Federal legislation pertaining to combinations has embodied a policy of opposition to monopoly and combination in restraint of trade and in favor of a competitive system. The most important of this legislation are the Sherman Antitrust Act of

1890, the Clayton Act of 1914, and the Federal Trade Commission Act of 1914, but the same philosophy has been incorporated in other legislation. On the other hand, an increasing number of industries have been made exempt from the provisions of the antitrust laws. Industries exempted include farmers' coöperative marketing associations, combinations in the export trade, pools of shipping companies, and railway pooling agreements. The Robinson-Patman Act of 1936 and the Tydings-Miller Act of 1937 embody a somewhat different philosophy from that of earlier antitrust legislation.

The antitrust laws have been only partly successful. Many varied opinions are expressed concerning the degree of success achieved by the government in its antitrust policy. The variety of opinions is in itself an indication that success has been only partial. The extent of competition and monopoly is aptly indicated in the following statement:[1]

> Somehow public policy and current reality are at serious odds and industries have not been subdued into such well-behaved affairs. Hardly a trade exhibits the neat purposive lines of the legislative pattern. Every industry has its vocabulary, its trade practices, its common understandings, without which it could not carry on. On all sides the rivalry of isolated firms has been tainted by custom, by compromise, by collusion. Industries in their several designs present their zones of competition and their points of constraint; and across the industrial landscape lies a network of constriction—open here, loose there, tight over younder—which abridge the liberty of the trade or deny the freedom of the market. It is an odd fact that restraint of trade and competitive practice are inextricably intermingled; together they form a shifting pattern of control for an industry.

Enforcement of the antitrust laws has not been well balanced. The first difficulty arises in connection with the origin of the complaint. Investigations and indictments have usually followed tips and reports made by persons and firms which are adversely affected by the alleged violation of the law. Some cases are the result of reports published by newspapers and of investigations made by Congress, the Federal Trade Commission, or other agency of the government, such as the Temporary National Economic Committee. Consequently, enforcement has been spotty rather than consistent and uniform throughout all industries.

It is difficult to gather the facts after the investigation has been

[1] Walton Hamilton and Irene Till, *Antitrust in Action*, p. 3, T.N.E.C. Monograph No. 16, Government Printing Office, Washington, 1941.

started. The Department of Justice can obtain access to the private records of corporations only through the consent of the defendants, which is likely to be refused, or through the summoning of a grand jury.[2] The grand jury is not a satisfactory device, particularly in the early stages of an investigation, because it is costly and cumbersome and perhaps unfair to the defendent who proves not to be guilty.

The testimony of witnesses in an antitrust case is obtained only with much difficulty. The position of a witness may be that of customer, competitor, or member of the conspiracy. Customers and competitors hesitate to testify because of the danger of reprisals after the case has ended. A combination which controls an industry either completely or in large measure may be able to shut off the supply of raw material of a customer who has incurred their ill will. Through pressure upon lending institutions, loans may be refused or called and assistance in the marketing of new issues of securities may be refused. Repairs by service industries may be delayed, shipments by rail or truck may be missent, contracts may be cancelled, and merchandise shipments may be rejected. A witness may have much to gain by refusing to volunteer information or failing to give complete answers to questions because of the necessity for continuing upon favorable relations with companies in the industry.

The Department of Justice has made increasing use of the consent decree. A consent decree is a special arrangement which has been developed in antitrust cases. It results in a settlement of the controversy by the government and the defendants in a manner which is agreeable to both sides. The defendants may agree to do certain things which change the organization of the industry or the relations between the members and which bring about a condition in harmony with the law. After approval by the court, the case is considered settled without appeal and final decision by the Supreme Court.

The first consent decree was entered in 1906 in a case in which the Otis Elevator Company was the principal defendant. Since that time decrees have been accepted in more than 150 cases. The industries affected include cash registers, radios, motion pictures, retail credit, live poultry, fisheries, confectionery, barbers' supplies,

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[2] Milton Handler, *A Study of the Construction and Enforcement of the Antitrust Laws*, p. 90, T.N.E.C. Monograph No. 38, Government Printing Office, Washington, 1941.

and meat packing. During the war period, arrangements were made for the modification of restrictive agreements in such industries as synthetic rubber, magnesium, aluminum, nitrogen, dyestuffs, and military optical instruments.[3]

An advantage of the consent decree is that it brings the Department of Justice and the defendants together in an informal manner to work out a solution of the problems of the industry which will be acceptable to all concerned. In such a meeting, the spirit of friendliness rather than of contention usually prevails. It eliminates the necessity for the collection of evidence, speeds the decision, and reduces the costs of the suit for both sides. There is no doubt that the production of many commodities essential for war was speeded up through the use of the consent decree.[4]

The consent decree has several limitations if not positive dangers. Since the defendants are frequently both natural persons and corporations, the natural persons may sell out the corporation in order to save themselves. The corporation may make concessions not required by law in order than it may avoid unfavorable publicity, uncertainty, and additional legal expense. The result may therefore be an indirect regulation of industry by the Department of Justice not contemplated by the law.

Numerous difficulties may be encountered in the carrying out of the decree. If a corporation which was a party to a decree is subsequently merged with another, the successor corporation is not bound by the decree because it was not a party to it. Neither the Department of Justice nor the court is organized to follow through and to exercise a continuous supervision over industry to see that a consent decree is complied with year after year. Therefore, the consent decree may fail adequately to protect the public interest.

The difficulties of law enforcement have been increased by the change in competitive practices. When uniform prices are charged or uniform bids are submitted by two or more companies in an industry, it does not necessarily follow that a combination in restraint of trade exists. In fact, in a competitive system, it is to be expected that one business will meet the prices of another. Almost all department stores maintain comparison departments to keep the store informed of the prices charged by competitors, and it is generally

[3] See Thomas K. Fisher: "Antitrust During National Emergencies," *Michigan Law Review*, June, 1942, Vol. 40, pp. 1161-1191.

[4] See Maxwell S. Isenbergh and Seymour J. Rubin: "Antitrust Enforcement through Consent Decrees," *Harvard Law Review*, Jan., 1940, Vol. 53, pp. 386-414.

considered good business policy not to attempt to ask higher prices than competitors charge. Uniform prices may therefore indicate the existence of keen competition.

Price leadership is another reason for uniformity of prices. Since there is no collusion and no conspiracy of competing companies, price leadership is legal. The United States Supreme Court has said of price leadership that "the fact that competitors may see proper, in the exercise of their own judgment, to follow the prices of another manufacturer, does not establish any suppression of competition or show any sinister domination."[5] While this attitude is undoubtedly correct, it is not easy to prove the suppression of competition or the domination of an industry by an association of companies when identical secret bids are submitted on contracts or uniform prices are charged. The situation is described in the following statement:[6]

> An overt agreement to limit production, to allocate output, to fix price—unless a validating sanction is at hand—is now passé. It thrives currently only in the quieter back country of the national economy—in the medical profession, among trade unions, in a highly competitive industry whose members must in explicit terms bind themselves not to kick over the traces. But the up-to-date industry is streamlined against testamentary exposure. The informal understanding, the telephone accord, the accepted gesture which all are to follow is enough. In segments of the industrial system even such forms of collusion are fading into disuse. A general acceptance of the same notion of a fair mark-up, of the same terms for a cost-into-price formula, of an established system of delivered price turns the trick. A "moral front" may restrain the chiseler whose practices are a menace to the industry; yet the ties that bind may be so ethereal as to be invisible to the law.

The rule of reason has added to the confusion. Although the rule of reason was entirely irrelevant in the oil and tobacco cases of 1911 where it was first announced, it has been important in several recent decisions. In holding the Appalachian Coals, Inc., to be legal, the Supreme Court admitted the legality of a reasonable restraint of trade upon the theory that prices were unduly low and that unemployment in the industry was a serious menace.[7] This decision was rendered in March, 1933, at the time of the nationwide bank holiday, and the disheartening business outlook may

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[5] United States *v.* International Harvester Company, 274 U.S. 708 (1927).

[6] Walton Hamilton and Irene Till, *op. cit.*, p. 54.

[7] Appalachian Coals, Inc. *v.* United States, 288 U.S. 344 (1933).

have influenced the decision of the judges. Nevertheless, it will be used as a precedent in other cases. Another case in which the rule of reason was a factor was the decision establishing the legality of the agreement for the cross-licensing of patents in the oil industry in 1931.[8]

Since reasonable restraints of trade are legal while unreasonable restraints of trade are not, the government has no satisfactory standards for selecting cases for prosecution with any assurance of success. Likewise, business enterprise has no way of determining in advance the validity of any concerted action, even though the principal purpose may be to eliminate waste or to reduce the costs of production or distribution. The administrative departments of the government are also unable to give advice with respect to a proposed coöperative plan in industry because a position taken in any one case may prove to be unwise as a precedent in other cases.

The number of decisions under the antitrust laws has not been sufficient to develop a unified body of legal principles. Since the laws of Congress are stated in general terms, the application of a law to a specific problem depends upon the interpretation of the courts. The value of court decisions in determining the legality of a proposed merger or other combination is decidedly limited. One difficulty is that the Department of Justice has not had the funds or the staff to prosecute a large number of cases. The cost of a case which is contested all the way to the Supreme Court may be as much as $150,000. Because of the relatively small number of decisions rendered by the Supreme Court in antitrust cases, a unified and consistent body of legal principles has not been formulated.

Several other problems confront anyone who would attempt to say whether a proposed act is legal or illegal. Many of the decisions have been rendered by a divided court, and some of them have been decided by a majority of five to four or even of four to three. Decisions handed down a few years ago are not entirely reliable because of changes in the personnel of the court. In some instances the minority opinion has later become the majority opinion. A relatively insignificant variation of the facts might be sufficient to affect the opinion of one or two justices and to change the decision of the court. Thus, the legality of new methods and practices in industry is not easily determined.

Proposed consolidations and acquisitions are frequently dis-

[8] Standard Oil Company (Indiana) *v.* United States, 283 U.S. 163 (1931).

cussed with government officials. Because of the uncertainties of the law, businessmen now regularly call at the Department of Justice to discuss their plans for the acquisition of the plants of competitors, the purchase of a controlling interest in the stock, consolidations, and coöperative agreements.[9] Representatives of the government lack authority to render an opinion which would bind the attorney general or the courts, but they may express an informed and informal opinion which is of value to private business in working out its plans. However, the Department of Justice is not adequately organized to render such opinions, and the officials may hinder effective enforcement of the law in the future by making statements which may later be used against the government. Such conferences are not entirely satisfactory to either business or government.

A codification of the law by act of Congress has been recommended. Numerous questions concerning the meaning of the antitrust laws have been raised in arguments presented to the courts in antitrust litigation, and many issues have been considered by the judges. In the various controversies, the lawyers for opposing sides have advanced conflicting theories as to what Congress really meant, and the courts have been compelled to venture an opinion as to the meaning of the language used in the acts. Congress could therefore clear up many such questions by formulating and enacting a comprehensive, unified, and consistent statement of what the law is, for the guidance of all concerned.[10] A codification of the law could not be expected to answer all questions which might arise in the future, and the courts might find a rigid and detailed statement to violate some provision of the Constitution, such as the due process clause. However, the idea seems to merit serious consideration.

A commerce court to pass upon proposed combinations has been advocated. The commerce court would be authorized to review the plans for proposed consolidations and other coöperative plans in industry and to decide when they would violate the antitrust laws. A favorable decision by such a court would not prevent subsequent prosecution by the Department of Justice, and the Federal courts would still have power to dissolve combinations that were found to exist in violation of the law. The advantage of ad-

[9] Walton Hamilton and Irene Till, *op. cit.*, p. 87.

[10] For further argument for a codification of the law, see Milton Handler, *op. cit.*, p. 97.

vance approval would be that the participants in an approved plan would not be liable to threefold damages as provided by the Sherman Act. This liability has, in fact, often been a deterrent to cooperative activities of trade associations and other groups in industry. President Theodore Roosevelt urged the establishment of such a court as early as 1908. The proposal has been renewed by W. J. Donovan, Donald R. Richberg, and others on various occasions since that time.[11]

The objections to the establishment of such a court are: first, that because of the large volume of work to come before it, decisions might be too long delayed; and, second, that businesses cannot be relied upon to present adequate information as a basis for decisions. The work of the court would also be complicated by the necessity for frequent alterations and revisions of plans after their approval but prior to consummation.

A program for submitting proposed mergers, amalgamations, and acquisitions of stock in competing corporations to a government agency was outlined in a report prepared for the Temporary National Economic Committee in 1941.[12] According to this plan, no combination of competing corporations with total net worth of $5,000,000 or more would be legal without the advance approval of the Federal Trade Commission or some other agency. After investigation and hearing, the Commission would grant its approval provided the proposed combination meets the following requirements:

1. The acquisition is in the public interest and will promote efficiency and economy of production, distribution, and management.

2. It will not substantially lessen competition or tend to create a monopoly.

3. The corporations involved in the acquisition do not include one or more of the ten largest companies in the industry.

4. The size of the acquiring company will not be so great as to hinder competition in the industry.

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[11] W. J. Donovan: "The Need for a Commerce Court," *Ann. Am. Acad.*, Jan., 1930, p. 142; R. C. Butler: "Needed Changes in the Antitrust Laws," *ibid.*, p. 189; Donald R. Richberg: "A Suggestion for Revision of the Antitrust Laws," *Univ. of Pa. Law Rev.*, Nov., 1936, Vol. 85, pp. 1-14; Herbert M. Bratter: "Reforms in Antitrust Laws Drawn by New Deal Advisers," *Washington Star*, Jan. 16, 1938, p. C 1.

[12] Milton Handler, *op. cit.*, p. 88.

5. The acquisition will not so reduce the number of competing companies in the industry as to lessen the vigor and effectiveness of competition.

6. The acquiring company will not become so large as to be able to fix prices in the industry by price leadership or otherwise.

7. The acquiring company has not used deceptive or other unfair methods to induce others to sell out to it.

Registration of trade associations with a government agency is being advocated. Because trade associations are powerful organizations which may be used against the public interest, it has been proposed that their activities should be a matter of public record.[13] This could be accomplished by requiring them to file a registration statement with the Federal Trade Commission or other agency which would include information as to the membership, the officers, and the activities of each association. Annual or other periodical reports of all meetings, activities, and agreements would also be required. The reports would include a full stenographic account of all committee and business meetings, and the officers would be required to certify that reports were complete and that the members had entered into no agreements or understandings for the control of prices or production or the elimination of any phase of competition. Such registrations and reports would eliminate much of the work of investigation by the Department of Justice.

As a corrolary to registration by trade groups, the information now filed with various government agencies might be pooled and made available to all law enforcement officials and to committees of Congress. Much information concerning industry was filed with government agencies throughout the war period, such as the Office of Price Administration, the War Production Board, the War Manpower Commission, the Office of War Information, the Federal Trade Commission, the Bureau of the Census, and the Bureau of Foreign and Domestic Commerce. If the information could be centralized, duplication and over-lapping would be eliminated and the information would be of more value to all agencies. However, some of the information was submitted with the understanding that only the one agency would have access to it, and centralized files would probably not be easily accessible to all.

Present concentration in industry remains an unsolved problem. Even though a means may be found to prevent further concentra-

[13] *Ibid.*, p. 93.

tion in industry, the control now exercised in many industries by a few companies will continue unless a plan is devised for ending it or for bringing the industry under the supervision of the government. The solution is not easy. To dissolve the existing companies in order to make a slightly larger number would not be an adequate solution; for if the number of companies remains comparatively small, secret agreements would still be possible. If existing companies should be dissolved to form a large number of corporations, the results might well be injurious to the national economy. The outcome would probably be inefficiency, poor service to customers, decreased production, high prices, and losses to corporations and their security holders. An extension of the regulatory activities of the government may prove to be the only possible solution. This is especially true of industries which are overexpanded and which are affected with more than the usual public interest. Industries which have already been brought under government control include railroads, banks, building and loan associations, fire and other insurance, street railways, aviation, telephone and telegraph, gas and electric power, water supply, trucking, investments, and coal mining. It may be necessary to add to the list and also to make regulation more effective in industries now under government control or supervision.

The legal concept of interstate commerce has gradually broadened. The most narrow view of the meaning of interstate commerce was that adopted in the famous Knight case in 1895, which was the first important case to reach the United States Supreme Court under the Sherman Antitrust Act. In this decision, it will be recalled, a distinction was drawn between manufacturing, control of which was reserved to the states, and interstate commerce, which is subject to Federal regulation. While this decision is no longer a precedent so far as the antitrust laws are concerned, the Supreme Court has consistently maintained that a distinction must be drawn between manufacturing and interstate commerce. In holding the Guffey Coal Act unconstitutional in 1936, the court pointed out that the mining of coal is not interstate commerce, but that mining merely brings the subject matter of commerce into existence. It was held that one who produces or manufactures a commodity that he subsequently sells in interstate commerce has engaged in two distinct and separate activities. In his mining or manufacturing operations, he is subject only to regulation by the state; but in so

far as he sells in interstate commerce, he is subject to regulation by the Federal government.[14]

An essential element in interstate commerce, it has long been held, is the transportation of persons or goods. In the decision in the case of Swift and Company in 1905, as already pointed out, the idea was first advanced that interstate commerce is the flow of goods across state lines through various stages of manufacture and distribution, and that the limitation of free competition at any stage may be a restraint upon interstate commerce. This view has been adhered to or even expanded in several cases since 1905. In upholding the Packers and Stockyards Act in 1921, the Supreme Court declared that sales at the stockyards were not merely local transactions; for while they created a local change of title, they did not stop the flow but merely changed the private interests in the subject of the current.[15]

Recently it was held that fire insurance is interstate commerce and therefore subject to the provisions of the antitrust laws.[16] The court pointed out that there is a constant flow of communications across state lines concerning the writing of insurance, the transmission of premiums, and policy settlements, and that many instrumentalities of interstate commerce such as trucks are insured against fire. The court also mentioned that interstate commerce includes transfers of such intangibles as telephone and telegraph messages, the carrying of lottery tickets, and the driving of stolen automobiles across state lines. Interstate commerce may include noncommercial, sporadic, and illegal transactions which do not utilize common carriers or concern the flow of tangible goods. Previously it had been generally believed that fire insurance was entirely an intrastate affair within the control of the state. Although such matters as fire insurance may be subject to the Federal antitrust laws, other activities of fire insurance companies may continue to be subject to state regulation. On this point, the court said:

"For constitutional purposes, certain activities of a business may be intrastate and therefore subject to state control, while other activities of the same business may be interstate and therefore subject to Federal regulation. And there is a wide range of business and other activities which, though subject to Federal regulation, are

[14] Carter *v.* Carter Coal Co., 298 U.S. 238 (1936).

[15] Stafford *v.* Wallace, 258 U.S. 495 (1921).

[16] United States *v.* South-Eastern Underwriters Association, 322 U.S. 533 (1944).

so intimately related to local welfare that, in the absence of Congressional action, may be regulated or taxed by the states."

A policy toward international cartels depends upon developments in the field of international relations. The policy of the United States toward international agreements thus far has been largely the negative one of attempting to prevent cartels from gaining control over domestic production. Under the antitrust laws, such combinations are illegal if they result in a restraint of trade as they usually would. The Webb Act of 1918 permits American corporations to combine for purposes of regulating the export trade provided the domestic market is not affected, although it is difficult to see how a combination can control foreign markets without having some effect upon production and distribution within the United States. When a few companies control domestic markets and one or two control them abroad, some kind of informal, tacit, or secret agreement appears inevitable.

It has been pointed out in an earlier chapter that during the postwar era production in many countries, particularly in eastern Europe, is likely to be concentrated in a few companies. In some countries the state will control production and distribution through government ownership or regulation. Even in Germany, the destruction of centralized economic power which was called for by the Potsdam Declaration of August, 1945, may prove to be both incomplete and temporary in its effect. German industrialists have so long been accustomed to working together in cartel arrangements and under government supervision that the establishment of genuine competition or even of decentralized control of production will be difficult to achieve and maintain. In a world economy characterized by monopoly either with or without state control, a competitive system in the United States cannot function easily and effectively.

The fact that the United States emerged from the war without having its cities and industries ravaged by bombing or scourged by invading armies but with its productive facilities greatly expanded places it in an enviable position. The world needs the products of American industry for reconstruction and for the satisfaction of the permanent needs of its peoples. The position of corporations in the United States may therefore be so important that international cartels will not be able to divide world markets or limit production without our participation. The continuation of a competitive system in the United States, free of artificial restraints and agree-

ments, could do much to increase production, lower prices, and raise the standard of living throughout the world.

The policy of the United States and of other countries toward international cartels, combinations, production policies, and competition for world markets is a matter of the concern of all. Such policies eventually may not be determined by one country acting unto itself but may be a subject of international agreement after consultation between the major powers. If they should come to favor international control of world markets, our domestic antitrust policy would be radically affected.

Questions

1. What types of organizations have been exempt from the antitrust laws? Why should any organizations be exempt?

2. In what respects have the antitrust laws been successful? What is the reason for the statement that they have not been completely successful?

3. How does the Department of Justice learn of the existence of an agreement which violates the antitrust laws?

4. Why should a witness hesitate to aid the government in the prosecution of a combination which he thinks restrains trade?

5. How have methods of restraining trade in violation of the law changed since 1911? What have been the reasons for the change?

6. What is the difficulty in convicting corporations of restraining trade if the method used is price leadership? Under what circumstances is price leadership legal?

7. Is the rule of reason a sound legal doctrine? How has it created difficulties for the Department of Justice?

8. The Bureau of Foreign and Domestic Commerce in the Department of Commerce attempts to assist industry in the development of coöperative enterprises. How does the rule of reason affect its activities?

9. Since the Sherman Act was passed more than half a century ago and since numerous cases have been tried under the law, how does it happen that the meaning of the law is still somewhat uncertain?

10. What are the dangers involved in having officials of the government advise with business men concerning the legality of their plans? What happens if a citizen is advised that a plan is legal if it later is proved to be illegal?

11. What would be the advantages of having Congress enact a comprehensive statement of what was meant by the provision in the law which declared combinations in restraint of trade to be illegal? Would it be possible for Congress to anticipate all of the questions which would be raised by attorneys and courts in later cases?

12. What would be the advantage to private industry in having a commerce court to pass upon proposed combinations in advance? Would the final authority still be the Supreme Court of the United States?

13. What tests should be applied by a court or by the Federal Trade Commission in determining whether a proposed combination is in the public interest?

14. Should trade associations be required to register with a government agency and render annual reports covering all of its activities?

15. If an industry is dominated by six large corporations and if those corporations are found to be conspiring with one another to control prices and production, why can they not be dissolved to form sixty or more smaller companies? Discuss with reference to such industries as oil refining, steel production, or chain grocery stores.

16. What is a public utility? Are such industries the only ones affected with a public interest?

17. How has the concept of interstate commerce been broadened? What has caused the change in the idea of what is interstate commerce?

18. On what basis is fire insurance held to be interstate commerce? What difference does it make whether it is interstate commerce or intrastate commerce?

19. What is a consent decree? What are its advantages to the government and to private industry?

20. What are the limitations and the dangers of the consent decree?

21. Should the antitrust laws be retained? If not, what other policy toward industry should be adopted?

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